

**SARBANES-OXLEY AT FOUR:  
PROTECTING INVESTORS AND  
STRENGTHENING MARKETS**

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**HEARING**  
BEFORE THE  
**COMMITTEE ON FINANCIAL SERVICES**  
**U.S. HOUSE OF REPRESENTATIVES**  
**ONE HUNDRED NINTH CONGRESS**  
**SECOND SESSION**

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SEPTEMBER 19, 2006

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## **SARBANES-OXLEY AT FOUR: PROTECTING INVESTORS AND STRENGTHENING MARKETS**

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**Tuesday, September 19, 2006**

**U.S. HOUSE OF REPRESENTATIVES,  
COMMITTEE ON FINANCIAL SERVICES,  
*Washington, D.C.***

The committee met, pursuant to notice, at 2:10 p.m., in room 2128, Rayburn House Office Building, Hon. Michael G. Oxley [chairman of the committee] presiding.

Present: Representatives Oxley, Baker, Bachus, Royce, Kelly, Biggert, Fossella, Feeney, Brown-Waite, Neugebauer, Price, McHenry, Campbell; Frank, Kanjorski, Maloney, Watt, Hinojosa, Scott, Davis of Alabama, and Cleaver.

The CHAIRMAN. The committee will come to order. Consistent with the rule 3(f)2 of the rules of the Committee on Financial Services for the 109th Congress, the Chair announces that he will limit recognition for opening statements to the Chair and ranking minority member of the full committee, the Chair and ranking minority member of the Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises, or to their respective designees, for a period not to exceed 16 minutes, evenly divided between the majority and minority. Prepared statements of all members will be included in the record. The Chair now recognizes himself for an opening statement.

Good afternoon. This will likely be the final time I am chairing the Financial Services Committee, and the subject is most appropriate: the Sarbanes-Oxley Act. You may have heard of that. Although it is named for two chairmen, it is the product of our legislative process. Senator Sarbanes and I have received both credit and blame in approximately equal doses, actually more blame probably. Nevertheless, Sarbanes-Oxley was necessary given the substantial damage both to our capital markets and to individual investors.

The day I took office on July 21, 1981, Americans were faced with skyrocketing inflation and an Israeli-Lebanese conflict. Then-Federal Reserve Chairman Paul Volcker testified that day before the House Banking Committee and said, "Dealing with inflation is essential to our future wellbeing as a Nation." The Dow Jones Industrial Average closed at 934; the S&P 500 at 128. At that time, 6.9 million households invested in mutual funds. Mutual funds had total assets of \$241 billion.

Since that day, the American investor and our capital markets have weathered many events: the insider trading scandals and the savings and loan debacle in the mid- and late 1980's; the deflation of the Internet and telecom bubbles; and the 9/11 terrorist attacks; and perhaps the most daunting crisis for the American investor, the largest corporate scandals in American history in the inaugural years of this century.

Congress's response to these scandals was the Sarbanes-Oxley Act, signed into law on July 30, 2002. With this legislation, Congress set about restoring investor confidence in our capital markets by strengthening the financial reporting and generally raising the bar in our public companies.

Nearly every provision in the Act can be tied to improving the accuracy and reliability of corporate disclosures, which is at the heart of the Federal securities laws. Sarbanes-Oxley requires more timely and complete disclosure of material information and underscores the duties of the individuals and entities monitoring financial reporting from management and boards of directors to audit committees and auditors.

I believe that the Act has been a success. More Americans than ever are invested in the market. Over 53 million households own mutual funds, a nearly ninefold increase from my first day on the job. Americans now have \$9.5 trillion invested in mutual funds, 35 times as much as in 1981.

Today the Dow Jones Industrial Average and the S&P 500 are near their all time highs, and we have indeed become a Nation of investors. The Act, though, is still in its implementation stage, particularly for the most criticized of the provisions, Section 404, requiring management's report on internal controls and an auditor's assessment of this report.

I must note that Section 404 was not in the original House passed bill. So maligned is this provision that some are using it to try to impede the New York Stock Exchange/Euronext merger or to try to disrupt other potential cross-border exchange transactions, claiming that the Act will apply to companies listed solely in Europe, a claim that is simply false. Sarbanes-Oxley always has applied only to companies listed in the United States.

Ironically, Section 404, surely the most costly provision from the company's perspective, may be one of the most beneficial to investors. Companies—the board of directors, audit committees, and management—are more engaged in ensuring a proper system of internal controls over financial reporting. In a corporate board member survey, 81 percent of senior executives reported Section 404 compliance as a success, and 76 percent of senior executives believe Section 404 compliance has motivated improved internal controls. Stronger financial reporting benefits investors, and improved accounting transparency fortifies our capital markets.

That being said, Section 404 has proved costlier than originally anticipated. I continue to believe that these costs are due not to the text of the Act but to an overzealous implementation of these internal control provisions.

I commend our witnesses today, our former colleague, Chris Cox, Chairman, of course, of the SEC, and Mark Olson, Chairman of the Public Company Accounting Oversight Board, for leading efforts in

making this implementation effective and cost-efficient. I support their bold intentions to revise Auditing Standard No. 2 to provide further implementation and guidance to public companies and their auditors. I look forward to hearing their views on these efforts as well as the impact of Sarbanes-Oxley on investor confidence.

With that, I yield to the gentleman from Massachusetts.

Mr. FRANK. Thank you, Mr. Chairman.

I think it is appropriate that you be presiding at your last hearing on the legislation which bears your name, because I think it is an important part of the legacy that is built of bipartisanship and of sensible regulation, regulation that is market-enhancing rather than interfering with the market. I think that ought to be our watch word.

This is legislation written to help the market work better and that, I think, is the role that we should be trying to fulfill when it is necessary to do something and possible to do it in this way.

I also support your view that much of the criticism has been overborne. I was struck recently by an article, I think, in the New York Times, that a number of private companies not legally mandated to follow Sarbanes-Oxley are finding it useful to adopt some of the procedures, that they find this enhances their reputation, that this enhances their ability to deal with a whole range of other parties, lenders, customers, potential partners and venturers and others.

I do agree that there is now some need for change, and I have to say, if having enacted something this far-reaching—and I can't claim a lot of credit for this. I was not the ranking member at the time. Former colleague John LaFalce was, and he deserves a great deal of credit because he was a leader, as you know, Mr. Chairman, in that effort with you. But as I look at this, it would be very surprising if we had gotten it 100 percent right the first time in a somewhat new area. So, clearly, there is room for change.

I do believe that the essential legislative structure is sufficiently flexible, so there is no need for legislative change. And you and I have had conversations with both of our witnesses, and I think there clearly is enough flexibility in the statute as written for the SEC and PCAOB to be able to make the adjustments that are necessary.

This can be made less burdensome without in any way compromising its core purpose. I look forward to our witnesses being able to do that in their respective agencies, and my hope is that, early next year at some point or next spring, we will see some revisions that they have both put through that will make this more flexible; as I said, less of a burden but without any serious imposition. I think some of the burdens have been exaggerated, but I think, in some cases, more has been required of people than we ought to be requiring, but in a framework which allows them to cut back on some of the excessive rules and regulations without compromising the core.

So I am glad that we are having this hearing in which we can reinforce what I believe is a consensus view in the Congress, not unanimous, but representative of a very large number of us, and I look forward to their doing it. Thank you.

The CHAIRMAN. I thank the gentleman.

The chairman of the subcommittee is running late, so we will recognize the gentleman from Pennsylvania, Mr. Kanjorski.

Mr. KANJORSKI. Mr. Chairman, just over 4 years ago, after a tidal wave of corporate scandals, we adopted the Sarbanes-Oxley Act. We are meeting today to review the effects of this landmark law on our capital markets. I believe that it has strengthened corporate responsibility, improved auditing results, and enhanced investor confidence.

Since the enactment of the Sarbanes-Oxley Act, however, we have regularly heard complaints from some parties about the cost of complying with the law. In particular, the statute provisions regarding internal control audits have become the subject of an extensive public debate. I would therefore like to focus my comments this afternoon on this area of the law.

We designed Section 404 to require publicly-traded companies and their auditors to assess a firm's policies, practices, systems, and procedures to prevent abuse, protect against fraud, and ensure proper accounting. This provision also requires companies to report any material weaknesses in these internal controls—and work to fix those problems—before financial reporting failures occur. This mandate helps public corporations to decrease their risk of future stockholder losses.

As I noted last year when we reviewed these matters, Section 404 has another important benefit: This provision is helping executives to better understand the financial reporting shortcomings within their companies, allowing them to recognize the nature of the problems earlier and adopt reforms and accounting procedures expeditiously. This work also is helping to provide important assurances to the senior officers of public companies who now must sign statements attesting to the accuracy of their financial statements under Section 302 of the Sarbanes-Oxley Act.

In May, the Public Company Accounting Oversight Board and the Securities Exchange Commission announced the steps that they would take to improve the implementation of Section 404, particularly for small public companies. Hopefully these efforts will result in the establishment of a "roadmap" that provides smaller companies and their auditors with the tools needed to achieve the benefits of strong internal control without unnecessary cost.

In addition to addressing questions about Section 404 implementation, I hope that our distinguished witnesses will examine another budding issue: how the Sarbanes-Oxley Act affects listed companies when an American exchange like the New York Stock Exchange or NASDAQ purchases or merges with a foreign one. I would also like to know the thoughts of our expert witnesses about what reforms, if any, we should adopt to protect investors in our increasingly interconnected international capital markets. Is it, for example, timely to consider the creation of an international securities framework?

In closing, Mr. Chairman, today's hearing is a fitting way to end your Congressional career. As the Public Company Accounting Oversight Board and the Securities and Exchange Commission work to implement the law that bears your name, it is appropriate for us to review their progress.

The CHAIRMAN. The gentleman's time has expired.

We now turn to our distinguished witnesses. Chairman Cox, we will begin with you.

**STATEMENT OF HON. CHRISTOPHER COX, CHAIRMAN, U.S.  
SECURITIES AND EXCHANGE COMMISSION**

Mr. Cox. Thank you very much, Mr. Chairman, Ranking Member Frank, and members of the committee. I very much appreciate being invited to testify on behalf of the Securities and Exchange Commission concerning the impact of the Sarbanes-Oxley Act of 2002. As you know, I have submitted formal written testimony that has been approved by the entire Commission. With your permission, I would like at this moment to summarize that testimony and also to add a few of my own thoughts.

The CHAIRMAN. Without objection.

Mr. COX. As I mentioned, I am especially pleased to be here, but particularly so because I am sitting next to Chairman Mark Olson of the Public Company Accounting Oversight Board. We are working together very closely to implement the Sarbanes-Oxley Act.

On this fourth anniversary, I would like to begin by recognizing the leadership of this committee under Chairman Oxley, Ranking Member Frank, and Ranking Member LaFalce. When President Bush issued his 10-point plan to improve corporate responsibility and to protect America's shareholders on March 7, 2002, in the wake of the collapse of Enron, this committee put forward a blueprint that contained many of those elements. Most of the essential provisions of this committee's legislation were included in the conference report in the final Sarbanes-Oxley Act.

As a member of this committee, at the time, I well remember the significant work that preceded the drafting of the legislation, including extensive hearings and the considerable effort that you led to shepherd the bill through the legislative process. I particularly remember the House-Senate conference and the immediately evident significance of the eventual product, the most sweeping modernization of our system of securities regulation since the initial enactment of the Federal securities laws more than 70 years ago.

Even though it has only been 4 years since the passage of Sarbanes-Oxley, the law has done already what few other Congressional enactments can claim: It has entered the popular culture. It has its own acronyms, its own nicknames, SOX and Sarbox. It has its own devoted Web sites, including an advice column titled, Dear Ms. Sarbox.

But most impressive by far is that, in addition to having spawned an entire industry of books and seminars, SOX now has its own dummies book: Sarbanes-Oxley for Dummies. Mr. Chairman, the SEC and the PCAOB have been working hard to make 404 compliance easier and less expensive, but it would seem that the marketplace has once again innovated more quickly than the government and delivered the desired result for a mere \$14.95, and unlike the Commission's guidance, this has cartoons.

But surely this is a welcome sign not only that SOX has achieved iconic status but also that its precepts have entered the popular culture. With this publication, it has joined the ranks of many other enjoyable and popular pastimes, as evidenced by such titles

as Wine for Dummies, Poker for Dummies and Formula One Racing for Dummies. Those are real titles.

The thrust is that, for many good reasons, the legislation we are meeting here today to discuss has had a very positive effect on corporate governance and on accounting transparency in America. We have come a long way since 2002. Investor confidence has recovered. There is greater corporate accountability. Financial reporting is more reliable and transparent. Auditor oversight is significantly improved.

The legislation that this committee produced 4 years ago under your leadership, Mr. Chairman, has helped make that happen. The Act is not perfect in every respect, but the vast majority of its provisions are net contributors to the Nation's economic health. Those parts of Sarbanes-Oxley that aren't working as well as they should, notably Section 404, could be made to work better through better implementation. Chairman Olson and I are hard at work on that.

But before providing an update on the Commission's efforts to provide better implementation of the Sarbanes-Oxley Act, I would like to highlight a little-noticed fact. While competitors in other countries are using Sarbanes-Oxley as a reason for foreign companies to list in their jurisdictions, many of those same countries are adopting provisions of the Act as part of their own regulatory regimes.

As we consider the effect of Sarbanes-Oxley on U.S. competitiveness, it is important to keep in mind how broadly many of its provisions have been taken up overseas. It would appear, 4 years later, that America's approach is not unique; we have just been early adopters. Of course, each country has implemented these reforms in slightly different ways, depending on their national legal system, on their market conditions and on other factors. But it is remarkable how similar so many of their reforms are to those passed by the Congress 4 years ago.

Let me give you just some of the examples. Governments in major markets around the world have established independent auditor oversight bodies like the PCAOB. For example, the European Union recently adopted a directive requiring all EU member states to create an auditor oversight body. There is now widespread agreement that to improve audit quality, the auditor oversight body should be independent of the industry they oversee.

Other major capital markets have also recognized the conflict of interest that some non-audit services create and the need to place restrictions on these services to improve audit quality. The European Union, United Kingdom, France, Hong Kong, China, Japan, Australia, Canada, and Mexico have all passed reforms requiring mandatory audit partner rotation, although they vary regarding the details about how this rotation works.

Audit committee independence is another increasingly common theme around the world. United Kingdom, Hong Kong, Australia, Canada, and Mexico have all introduced reforms since 2002 requiring all members of the audit committee to be independent of management. A number of countries have even adopted requirements similar to the first half of the controversial Section 404 of Sarbanes-Oxley which requires management to do its own assessment of the company's internal controls over financial reporting. Several

countries, including the United Kingdom, Australia, and Hong Kong have adopted a comply-or-explain approach to a management assessment.

Japan, France, and Canada all now have legislation or regulation requiring a management assessment of internal controls. Still others, such as Mexico, have corporate governance codes that recommend having a management assessment of internal controls.

The problems that we have experienced implementing Section 404 arise from the regulatory interpretation of the second half of this provision, the part that requires an auditor attestation to management's assessment, and just as in America, that aspect has proven more controversial abroad than the assessment itself.

Despite the controversy, however, several other jurisdictions have adopted some variant of this requirement. For example, the United Kingdom requires auditors to report on a comply-or-explain basis if they believe management's assessment is unsupported. In China, France, and Japan, there are now rules requiring an auditor's evaluation of management's report on a company's internal controls but with some differences in the manner in which the evaluation is to be conducted that make it far less costly.

Some countries, including Brazil and Australia, require an evaluation but don't require that the evaluation be made public. Instead, they require the auditor to report the evaluation to the board.

Another trend is for corporate governance codes to include a non-binding recommendation for auditor evaluation. That is done in Germany and in Mexico. Still other jurisdictions, such as Canada, are taking a wait-and-see approach to determine the impact of the auditor attestation requirement here in the United States.

Not only with respect to Section 404, but with the entirety of Sarbanes-Oxley, the SEC will continue to work with other regulators around the world to encourage effective regulatory standards that promote capital formation, job creation and economic growth while at the same time offering a high degree of investor protection.

As the Congress full well appreciated when it passed Sarbanes-Oxley, these aren't inconsistent goals, but rather, they are highly complementary ones. Since President Bush signed the Sarbanes-Oxley Act in 2002, the Commission has completed nearly 20 rulemakings and studies that were mandated by the Act. And since 2004, the legislation has resulted in the largest public companies representing over 95 percent of the total U.S. market capitalization becoming subject to all of these new rules mandated by Sarbanes-Oxley.

The Section 404 requirements, as I have said, have gotten by far the most attention, but I would like to mention some of the specific improvements that have profoundly and positively affected corporate America, public investors and the important work done every day by the Commission throughout the rest of the Act. One of the principal objectives of the Act was to improve executive responsibility and the tone at the top in America's public companies. We can credit two sections of the Act in particular for helping to achieve that objective, Sections 302 and 906. A fraudulent Section 302 certification is subject to civil enforcement by the Securities

and Exchange Commission, and a fraudulent Section 906 certification is subject to criminal enforcement by the Department of Justice. These dual certification requirements are designed to ensure that the company's top leaders are personally involved in the disclosure process.

It is one of the hallmark accomplishments of Sarbanes-Oxley that we now have the corporate equivalent of President Truman's oft cited aphorism: "The buck stops here." Thanks to SOX, the responsibility for the truthfulness of public company corporate reporting and disclosure stops on the desks of our corporate leaders.

Another very significant improvement was made by Section 301 of Sarbanes-Oxley. This section embodies the Congress's view that audit committees play a vital oversight role in the financial reporting process. The SEC's rules under Section 301 require that the audit committees of all listed companies be independent. They alone are responsible for the appointment, compensation, retention and oversight of a company's outside auditor, and the auditor must report directly to the audit committee.

The audit committee also must establish the level of funding necessary to fulfill its duties including, if necessary, the retention of independent counsel and other advisors. That is a very significant change. We have long held that independent auditors ought to be independent, but their independence rested in large part in the past on their ability to deal with the sometimes conflicting demands from the same executives who selected them and who determine their fees. Today's independent audit committees, thanks to Sarbanes-Oxley, can retain their own counsel and advisors. They now have the resources and the protection that they need to carry out truly independent evaluations.

Beyond the independence of audit committees, Sarbanes-Oxley has strengthened auditor independence. The entirety of Title 2 of the Act is devoted to that topic. The intense focus on auditor independence reflects Congress's appreciation that the audit process is most effective when investors are assured that audits are performed by objective and unbiased professionals. The Act bans auditors from providing the kind of non-audit services to audit clients that could give rise to financial conflicts of interest. It emphasizes the role of audit committees in approving other services by auditors, and it requires audit partner rotation. All of this is more protection for investors and less incentive for the auditors to do anything that detracts from their core mission.

In January 2003, the Commission amended its auditor independence rules to conform to the Act. As with all of our rules, we are continually monitoring the implementation of these rules as we respond to requests from companies and accounting firms for interpretive guidance.

Our current enforcement efforts focused on the backdating of stock options demonstrate the importance of these changes in Sarbanes-Oxley when it comes to real-time reporting. It was a significant improvement brought about by Sarbanes-Oxley that now there is real-time disclosure of material information by companies and insiders.

Thanks to changes mandated by the Act, investors are entitled to review reports of insider transactions, including the receipt of

option grants, within 2 business days after the transaction occurs. And all of these reports are now required to be filed on EDGAR, the SEC's Web-based disclosure system. The real-time reporting of grants has eliminated much of the opportunity for backdating that existed before the law took effect.

One of the most significant changes made by the Sarbanes-Oxley Act was the creation of the Public Company Accounting Oversight Board. Investors have been blessed with an exceptionally high caliber of leadership at the PCAOB. Since I became Chairman of the SEC, it has been my privilege to work first with Chairman Bill McDonough, then acting Chairman Bill Gradison and, most recently, Chairman Mark Olson, who took the helm this year. Chairman Olson is familiar to most of you on this committee, having served with distinction as a Governor of the Federal Reserve Board of Governors, among other notable positions.

Chairman Olson is now working closely with the Commission's new Chief Accountant, Conrad Hewitt, who is a distinguished leader of the accounting profession and the former chief financial regulator for the State of California, as we continue our joint efforts to improve investor confidence in the reliability of audit reports.

As I conclude, I would like to turn now to the one notable exception to the largely positive record of change wrought by the Sarbanes-Oxley Act. The Section 404 internal control reporting requirements as they have been implemented to date have met with a variety of criticisms, particularly from smaller companies. What we have learned from our Section 404 compliance efforts to date is that the problems issuers have experienced thus far are not inherent in the language of the statute but stem rather from the method of its implementation.

We have also become convinced that there are no irreparable problems with Section 404 implementation, although fixing the problems that we have identified will be challenging. We are working with the PCAOB to ensure this provision of the law is implemented efficiently and effectively.

Larger domestic companies with a public float of \$75 million or more have now been fully subject to Section 404 requirements for two full reporting seasons. We have been carefully monitoring compliance efforts each step of the way. On the basis of this experience, we can report that, while implementation efforts thus far have resulted in significantly greater than anticipated costs, compliance with Section 404 nonetheless produces significant benefits. Chief among these benefits is a heightened focus on internal controls at the top level of public companies.

While a portion of the first-year compliance expense undoubtedly reflected start-up costs and, in many cases, long neglected maintenance of internal control systems and procedures, it is undeniable that some of the costs were attributable to excessive, duplicative or misdirected efforts on the part of companies and their registered public accounting firms.

In response to concerns about these unnecessary costs, the Commission directed the staff to issue additional guidance. The guidance emphasizes that it is management's responsibility to determine the form and level of internal controls appropriate for each company and to determine the scope of its assessment and testing.

The guidance emphasized that the registered public accounting firms must recognize a range of reasonable choices by companies acceptable in the implementation of the Section 404 requirements. The PCAOB issued complementary guidance in May and November of 2005 regarding the application of its Auditing Standard No. 2, and then, in May of this year, the SEC announced a plan to rebalance Section 404 compliance by all of the companies that fall under our jurisdiction, large and small, foreign and domestic.

On May 17, 2006, the Commission issued a road map laying out the specific steps we plan to take to make Section 404 compliance more efficient and cost effective. One of the significant steps on that road map was the publication on July 11th of a concept release as a prelude to the issuance of SEC guidance for management on how to assess the effectiveness of a company's internal controls. The public comment period on the concept release just closed yesterday.

In addition, last month, the Commission proposed to grant further relief from the Section 404 reporting requirements to smaller public companies. The initial compliance date for these companies would be extended until fiscal years ending on or after December 15, 2007. The Commission also proposed to extend the date by which smaller companies, so called non-accelerated filers, must begin to comply with the section 404(b) requirement to have an auditor's attestation as part of their 404 compliance. This deadline would be moved to the first fiscal year ending on or after December 15, 2008.

As a separate action, in August, the Commission granted relief from section 404(b) compliance for certain foreign private issuers that are accelerated filers, and that, according to Commission data, about 23 percent of the approximately 1,200 foreign private issuers will receive the one-year extension.

As this brief summary makes clear, Mr. Chairman, much has been accomplished to strengthen and restore integrity to the U.S. capital markets since the enactment of Sarbanes-Oxley 4 years ago. In a time of crisis, you, then Chairman Sarbanes, this committee, and your colleagues in the Senate stepped forward to champion these significant reforms to our regulatory framework. Your vision and responsible judgment, Mr. Chairman, along with Ranking Member Frank, Ranking Member LaFalce, and the other leaders of this committee, has been absolutely essential in maintaining the standards in our securities market as the best in the world and in giving America's investors the strongest protection in the world and in providing them with a higher level of confidence than they can have anywhere else on earth.

In the months and years ahead, we will continue to work to implement the critical reforms affected by the Sarbanes-Oxley Act in the best way possible to meet our objectives of investor protection, well-functioning markets and healthy capital formation. We won't forget the failures that plagued our markets at the dawn of this millennium and the crisis of investor confidence that ensued. We will do our best to honor your legacy by ensuring that Sarbanes-Oxley works for every stakeholder; for investors, for issuers, for our economy, and for our country.

I appreciate the opportunity to appear before this committee on behalf of the Commission, and I look forward to answering your questions.

[The prepared statement of Chairman Cox can be found on page 56 of the appendix.]

The CHAIRMAN. Thank you, Chairman Cox, and thank you for your very comprehensive testimony.

We are pleased now to have the relatively new Chairman of the Public Company Accounting Oversight Board, Mark Olson.

Welcome back.

**STATEMENT OF MARK W. OLSON, CHAIRMAN, PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD**

Mr. OLSON. Thank you very much, Mr. Chairman, Ranking Member Frank, and members of the committee. I join with the others, Mr. Chairman, to thank you for the work that you have done not only on this effort but on many others over the years and the times that I have had a chance to work with you from my various roles in the past; we all thank you.

I have, as you know, submitted an extensive statement which I would like to submit for the record, and I would like in my opening statement just to include a summary of some of the issues, particularly those that have not yet been covered.

The CHAIRMAN. Without objection.

Mr. OLSON. I also would like to indicate how much I appreciate the opportunity to make this presentation in conjunction with Chairman Cox, whom I have already enjoyed working with in this combined effort.

Many of you talked about the environment that we were in 4 years ago when Sarbanes-Oxley was passed and some of the immediate repercussions of that environment. I won't repeat some of the things that have been said, but let me elaborate on some of the points from my perspective.

Immediately prior to joining the Federal Reserve Board, I served as the staff director of the Securities Subcommittee of the Senate, and some of you may know, we held extensive hearings that year on accounting issues. And it is instructive, I think, to remember that, at this time immediately following the tech boom and then bust, there was a significant focus on the inadequacy of GAAP accounting to capture value in corporate America. GAAP accounting in the United States had been constructed in significant part to capture value in a bricks-and-mortar era, and increasingly, corporate value was in intellectual property, in human capital, ideas and the like.

However, throughout that entire discussion, there was an underlying presumption that the accounting that was there was good, could be in fact relied upon, and then the accounting scandals of Enron, WorldCom, Global Crossing, and the like came and shook that underlying confidence.

By that time, I was on the Federal Reserve Board, and we could measure in a sense what happened in the U.S. economy as a result of that lack of confidence. There is an old longstanding economic principle that you can measure risk, but you cannot measure uncertainty. And in an environment of uncertainty, there was a very

significant element of risk-aversion. We saw it in corporate America. We saw it in the contraction of, in a significant way, the U.S. economy. Frankly, we saw it in the accounting profession that, at that time, were readjusting some business models, and I think the resulting implementation of Sarbanes-Oxley, I think, reflected some of that same uncertainty.

The passage of Sarbanes-Oxley, which created title 1, which created the PCAOB, essentially did two things: It replaced the accounting industry's self-regulatory organization, which frankly had failed it during this time; and it replaced it with an independent agency, and as Chairman Cox indicated, that model to a greater or lesser extent is being adopted throughout the world.

Also, it required that we inspect the accounting firms and the manner in which they are doing their audits from the perspective of the interests of investors. That is what we have been doing.

During the time that we have had in place the registration process, there are now 1,600 accounting firms that have been registered. Congressman Kanjorski talked a little bit about the international implications, and Chairman Cox made the same point. Of those 1,600, roughly 700 are foreign firms that either contribute in a significant way or partially in audits of firms that are registered in the United States. So there is, as all of you know, there is a significant—an increasingly global economy. We are finding the global interaction is very important, and we are gearing up to meet that.

We inspect now all registered firms by statute. All firms that perform more than 100 issuer audits, we inspect annually; and everybody else, every 3 years. Our inspection is quite different from the manner in which the SRO did in that it is much more risk-based, much more focused not simply on the extent to which the audit is done consistent with standards, but it looks at the overall auditing environment as well.

Chairman Cox and several others of you have commented also on Section 404. Let me just make some comments on 404 as well. As it was approved by the SEC, AS 2, the implementation of our AS 2 in June of 2004, the initial reaction was it was too burdensome, that the value did not equal the cost. And we fully agree that was the case. I think it was a combined over-reaction of the accounting industry, perhaps the SEC in the initiation of 404 and, in our case, in the implementation of AS 2. We responded quickly and continue to respond in order to help bring that cost-value paradigm into balance.

We issued interpretive guidance relatively quickly. In May of 2005, we issued a policy statement on how the audits could be made more effective. In November of that year, we evaluated the environment in which it was undertaken and acknowledged that there needed to be greater efficiency, and we are now in the process of making changes to AS 2, amending AS 2 in conjunction, as Chairman Cox indicated, with their concept release on 404.

I would like to mention that small companies are being significantly taken into consideration in this effort. Our guidance will emphasize the scalability. We have undertaken, and will continue to undertake, a series of training for auditors of small companies. These training sessions include the issuers that they audit.

There have been some studies done on the implication of Sarbanes-Oxley in the marketplace, and as Chairman Cox pointed out, in particular when he talked about the audit committees and independence, in many instances, what Sarbanes-Oxley did was codify best practices. However, the boards of directors in particular have reassessed the roles of audit committees, and what we have found significantly—and since I have been in this role I have had many representatives of audit committees talk to me about the value of the internal controls and the value that they have realized in that independence. Congressman Frank mentioned, and it is clearly our experience also, that firms and not-for-profits that are not specifically covered under Sarbanes-Oxley are volunteering to increase the standards that they expect, and in order for some of those businesses or those not-for-profits to attract boards of directors, they are finding that there has to be a significantly heightened level of internal controls on their financial reporting in order to attract the people that they want.

The cost benefit, we would submit, needs to be evaluated over time, especially because the implementation will go out, as the chairman said, out to 2009. We won't fully know the cost benefit until that time, but there are some indications that the cost benefit is being realized. The U.S. capital markets are by far the largest and the deepest in the world. Foreign issuers that are issuing now in U.S. markets are increasing as a percent of the total number of the IPO's, and the listings on U.S. firms command evaluation premium vis-a-vis the issuers in other markets, so we are already starting to be able to measure some of the value that we see of Sarbanes-Oxley. And, Mr. Chairman and members of the committee, I would submit that is the type of grade and that is the type of evaluation that we are prepared to live with, the extent to which U.S. markets continue to be strong and the value of Sarbanes-Oxley at least equals their additional cost.

I might say in closing, however, that there has been one significant failure. The order of the letters in the name does not lend it self to an acronym that roles easily off the tongue, and if there is a way that that can be changed without opening up the statute, Mr. Chairman and members of the committee, we would much appreciate that. Thank you. I look forward to answering your questions.

[The prepared statement of Mr. Olson can be found on page 65 of the appendix.]

The CHAIRMAN. You mean peekaboo doesn't work?

Mr. OLSON. That is not our favorite.

The CHAIRMAN. Let me first of all thank both chairmen for an excellent presentation and an excellent overview of where we are have been. Since I have been living with this now for over 4 years—and I get a lot of free advice as I am sure you do as well—and most of the criticism, of course, centers around 404, though I have another favorite that I want to bring up a little bit later.

I think sometimes memories are short about the atmosphere that we were legislating in. The gentleman from California remembers well, and, as I say many times publicly, it was the atmosphere towards corporations in general, and CEO's in particular, during those difficult times that was kind of summed up by what I would

hear at home which was pretty much, let's give them a fair trial and then hang them.

I say this because I think in, clearly, my 25 years in Congress, never has the Congress legislated in such a superheated atmosphere. And it was unique. And given the response, given the facts before us, I think overall we responded pretty effectively despite the fact that nothing is perfect, and time allows us to perhaps take a look at some of the changes that we could do.

To that end, let me ask both of you, in the area of 404, clearly, the implementation has proven more costly than had been anticipated. What, in both of your judgments, caused that specifically? And secondly, are you considering regulatory changes that would move more towards a risk-based approach to implementation of 404?

I guess, Chairman Cox, we will begin with you.

Mr. COX. I would start in answering the first part of your question about what specifically caused the excessive cost in early implementation of 404 with the divergence from the plan in the statute. Section 404 is not very long. You can read it in under a minute. It has two parts: The first part requires the company to self-assess, to take a look at its own internal controls and determine whether or not they are effective. Part two requires the auditor, in the context of doing the overall audit of the company, to attest to whether or not management did that.

What has happened in practice or what happened in the early going was that part A was completely subsumed in part B, and the entirety of the exercise was an auditor-driven exercise. The bulk of, in fact, the only real guidance provided by the government was in the form of an auditing standard, and the auditing standard was about 400 pages long. That occupied the field.

And so the fact that this was not a management-driven exercise, that management had no guidance in how to make it such, resulted in a lot of audit-type approaches to the management's assessment of itself.

The basis for the statute, as everyone on this committee full well knows and remembers, was existing Federal law. Section 404, nearly word for word, was borrowed from the FDIC Improvement Act, and, in the FDICIA context, we had no experience with the kind of outcry we had seen following implementation of Section 404, so there was really no way for Congress to predict based on our experience, based on the legislative history, what actually happened.

We now know, on the basis not only of that early experience but very deliberate efforts, roundtables of the SEC where we call in issuers, practitioners, auditors and so on and discuss this in the manner of a Congressional hearing, how to make this problem abate and how to get more bang for our buck.

The main point here is not that 404 implementation didn't work; everybody seemed to think it provided benefits. The only question is, how much did those benefits cost the investor, and were they worth it, because we are spending the investor's money? So the process that we are embarked upon now is designed to squeeze out all the excessive costs and in particular any part of this effort that is unrelated ultimately to making those financial statements good

and solid. If it doesn't affect the financial statements, if it is not material, then a risk-based approach is going to spend resources elsewhere. And we think we can do that.

So that gets to the second half of your question, will we be moving to a risk-based approach, and that is one of the touchstones of what the SEC and the PCAOB are doing with this now.

The CHAIRMAN. Thank you.

Chairman Olson.

Mr. OLSON. Just to supplement some of the things that Chairman Cox has said, it was the symbiotic over-reaction, I think, of the accounting industry, the PCAOB, probably the SEC and maybe others, I think, in not only the manner in which we provided the initial guidance—I think we provided it with some specificity and with some complexity that may have contributed in some ways to an over-reaction or a sense that the accounting, that the auditors would need to do more procedures than, for example, what was the case either in the previous standards or FDICIA 112.

We did put out some subsequent guidance reminding the accounting profession that the intention is that it be a risk-based approach. In fact, the manner in which we now inspect the accounting firms for the manner in which they do their audits of the internal controls for financial reporting focuses—anticipates it will be done in a very risk-based approach.

So what we are doing now prospectively is to make sure that the language is less technical, more specific, can be more readily, I think, understood, interpreted, that where there is some confusion on terms, we have tried to clarify those and at the same time focus on what is the fundamental expectation with respect to AS 2, is that issues of materiality can be focused on and identified prior to the time that it would require a restatement, and that is really the fundamental purpose.

The CHAIRMAN. AS 2 was what, some 300 pages; right?

Mr. OLSON. About 180, I believe.

The CHAIRMAN. And we would expect that the changes made should hopefully be shorter and more concise?

Mr. OLSON. Exactly.

The CHAIRMAN. One of the issues that I have not heard a whole lot about and yet it bothered me when initially it was added in the Senate is the whole issue of the corporate loans. It was clearly because of the \$400-million-plus loan that Bernie Ebbers got from apparently one board member's approval at WorldCom that triggered the amendment offered by Senator Schumer. Have you, have either of you taken a look at that particular provision and have any comment in that regard?

Mr. COX. Mr. Chairman, you and I have had the opportunity to discuss this, and I am certainly full well aware of the problem. The Act does not give the SEC, as we interpret it, the power to change it, and we do not have a rule right now implementing the provision.

The CHAIRMAN. Thank you. Did you have a comment?

Mr. OLSON. I do not.

The CHAIRMAN. Finally, and this is a bit off the subject, but in some sense, it really kind of puts a finer point on what was going through the body politic at the time. I get this question all the

time. What was the biggest mistake that anybody made in this whole process? Obviously, you would try to avoid self-implication, so I usually say—and I will be interested in your response—my response is that the biggest mistake I felt in this whole process was essentially the death penalty for Arthur Andersen, where we in a relatively short time went from the Big 8 accounting firms to the Final Four, and that the lack of competition in the accounting profession, at least to some extent, has driven costs up. I just would be curious as to your responses.

Mr. Cox. Mr. Chairman, I would like to answer that question in two parts, and the first part, what got us to that juncture, and then, second, how we reacted to it. But if one is looking for mistakes made, it is a big mistake to overlook what was going on inside Enron, inside Arthur Andersen, inside WorldCom. The scandals were real, and they were big, and they were major. And in this committee, we all sat through extensive hearings, and we had these people before the Congress and heard from them, and we looked at what went on inside Arthur Andersen.

Were it not for the egregious conduct that occurred in the marketplace, then whatever excessive response, if someone wants to call it that, that occurred later wouldn't have happened. So while I am happy to critique the fine points of the congressional response and the administrative response, I don't think we should for a moment fail to recall what got us to that juncture in the first place. And I think everyone on this committee could do a good job extemporaneously citing all those good reasons that brought us there.

I think that if there is a mistake or a fault in all of this, and I am not sure I am prepared to call it exactly that, it is the magnitude of the change that was wrought all at once. That is not normally the way securities regulation has proceeded over most of its history, with the exception of the initial creation of the Securities and Exchange Commission in 1934 and the passage of the 1933 Act, which really was a big change and a big shock to the system. But one of the things that has been a hallmark of securities regulation and which I always appreciated as a private practitioner is the care and the patience that the agency takes in putting things out for comment and listening to the marketplace and in making, wherever possible, incremental change rather than broad sweeping changes, because we are dealing with a big marketplace in the United States and around the world, and so we don't want to do experiments on a live patient.

So I think that the breadth of change, the magnitude of the changes that were undertaken all at once inevitably produced, as Congressman Frank mentioned, some anomalies that have to be addressed, and, in the case of 404, it is an expensive anomaly.

The CHAIRMAN. Chairman Olson.

Mr. OLSON. Mr. Chairman, I would like to address the question from a slightly different perspective. The combination of events that brought about the demise of Andersen were a sequence of legal actions which should appropriately be addressed to the Justice Department and the SEC. What I would like to do is talk to you about what may be some of the unintended consequences of the succession of events that led to that.

With Arthur Andersen, as we all know, there were some rogue actors at Andersen that helped bring about that demise, but from our perspective, Andersen had thousands of very talented people. And what immediately happened was a significant redistribution of that talent to the other firms so you saw all of the other firms, including some of the—some that are not among the four largest, gaining some additional talent. Some of our most capable people at the PCAOB were people who were with Andersen up to that point, and they are enormously valuable people.

The CHAIRMAN. You are occupying their former offices; is that correct?

Mr. OLSON. Yes, I am. That is one of the ultimate ironies. I think that one of the things that has happened as a result is, when we only have four firms and those firms are not simply dominating in the United States, but dominating around the world, it has impacted the manner in which the firms can compete. And I don't know that we fully appreciate or fully realize the significance of that, but I think that there is—the competition among firms is an issue that is on our minds and one that we are very concerned about in watching.

The CHAIRMAN. Thank you. My time has long expired.

The gentleman from Massachusetts.

Mr. FRANK. There appears to be a lot of agreement that there should be some changes, some refinements, more flexibility put in. Do you have enough authority under existing legislation to do that? That is from what you know now; obviously, we haven't completed the process. Is it likely to get done what you think ought to be done to get this working the way we want it to work, that you have to come back to get an amendment to the legislation, or do you have enough flexibility within the existing legislation to go ahead?

Mr. COX. I believe that we have ample authority administratively to apply Section 404 in a manner that is cost-effective and gets the job done for investors. I don't think there is anything inherent in the statute that makes it unduly expensive. I am willing to acknowledge that it has been, but I don't believe that is a problem with the law.

Mr. OLSON. I have the same answer, Congressman.

Mr. FRANK. Good. I think that is our view, too, and so I think we can look forward to some substantial improvement without having to reopen this.

You mentioned, Chairman Cox, FDICIA. I will note parenthetically for people who don't remember exactly, that was the law that we passed after the thrift bail-out situation to try to forestall a crisis or help forestall a crisis in the commercial banking area, and it was part of a very successful effort.

I must say, I remember in 1989—1988 into 1989—there was some skepticism among some journalists. They were saying, first the thrift collapsed and now the commercial banks are going to do it, and they just brushed it under the rug for the 1988 election.

In the years that follow FDICIA, not obviously entirely, maybe not even substantially because of it, but there were, I guess, the fewest bank failures in history; none for a while. And it did seem to be an example of a successful effort. I had not recalled frankly that the language was the pattern.

But that leads to a question. We have heard from some banks who are covered by FDICIA that they think they should be given an exemption from 404 on the grounds that they gave at the office and are already covered. What is the response to the suggestion that it is duplicative for them, that they are already under it? It is administered differently. Would that mean it is only up to the primary bank regulators, not you? We have just begun to hear from some banks who have raised that issue, and I would be interested in your response.

Mr. COX. Well, the first layer of response I would offer is that, with the exception of one-bank holding companies, the bank holding companies which have the 404 compliance requirement own more than banks typically, and so, with respect to a large bank holding company, it would be difficult to exempt them from 404 compliance. With respect to small community banks that happen to be one-bank holding companies, then I suppose that is something that you could entertain as a possibility legislatively.

Mr. FRANK. Is there a way to deal—has it been duplicated? What happens if you are a bank—I hadn't realized this before—and you are subject both to FDICIA and Sarbanes-Oxley? How does that interact? Is there coordination?

Mr. COX. I think the initial decision to interpret Section 404 of Sarbanes-Oxley differently from FDICIA even though the language was the same resulted in two different sets of compliance procedures and regiments, and so banks had to adjust and do both.

Mr. FRANK. That sounds like a reasonable issue that I would hope you would look at, and we ought to be able to—that one I guess would take legislation if we decided to make—

Mr. OLSON. Congressman, actually, we have made significant progress, the PCAOB has, in dealing with the bank regulators. As Chairman Cox pointed out, the most fundamental difference between the two is that FDICIA 112 applies only to the insured depository, and in some institutions, the insured depository constitutes virtually all of the assets of the holding company. In some, it does not. Now, what we have done in conjunction with the bank regulators is to give the bank holding company the option of either doing them separately or doing them in an audit that would include both. So because of the fact that there is that significant overlap, we have found ways to remove that element of overlap. In addition, the one other significant difference is that not only is it 404 that applies in that instance, but it is also a SOX 103 that requires certain things to be included in the report, and so that there is—they are not—they are not—they are not identical. But because of the significant overlap, we have been able to work with the bank regulators to eliminate a lot of the duplications.

Mr. FRANK. So this is another case where you think within the existing statute there is enough flexibility to accommodate that?

Mr. OLSON. I would say so.

Mr. FRANK. It just occurred to me that anybody who is not regularly employed either on the staff of this committee or one of your agencies who would understand immediately what someone meant if we talked about the PCAOB interpretation of FDICIA has a seriously deficient life.

Mr. OLSON. That hurts. I spent years and years in FDICIA 112, and now I hope to spend years and years on AS 2.

Mr. FRANK. Next question just is really retrospective about this, and that is, you know, the Congress I think talked sensibly about posing the counterfactual when you were trying to analyze things. I thought it was useful to do this. We talked about the history. In your—well, just factually, I would think that is perfect, but in the post-Sarbanes-Oxley world, it is my impression that there have been fewer of the massive major company collapses of the Enron WorldCom sort. Is it reasonable to conclude that Sarbanes-Oxley has been successful in diminishing the problem that it sought to fix? Has the world been less troubled, the corporate world, since, Mr. Cox?

Mr. COX. Well, it is undeniable that we are 4 years later in a much better place in our public markets, in our capital markets and in terms of investor confidence than where we were when this law was adopted. For social scientists let alone for Federal agencies, it is always a challenge to parse out correlation and causation. I can't prove that the status quo is the necessary result caused by the legislation, but it is certainly the case that we are at a better place today.

Mr. OLSON. The question will be if, 10 years from now, the lessons that were learned as a result of Enron, WorldCom need to be relearned by a new generation of management and accountants and supervisors; that, to me, as having lived through many cycles in the banking industry, it does seem to me that we need to relearn the same lessons over and over again. But I think what we have in place now is an element of discipline that wasn't there before. So I am encouraged that we can in a significant way, get out—recognize the potential weaknesses that we would see in the audit component and be able to address those.

Mr. FRANK. Well, I thank you. Obviously, it would be wrong to think that you make progress simply by making a new set of rules and hitting people if they don't follow the rules. They hopefully have some impact in reshaping the culture in which people operate. It does seem to me that that has been one of the successes. Certainly I had never paid much attention to corporate boards of directors before becoming the ranking member of the committee. I didn't hang out with that many, and I just didn't follow them that closely. And my first impression of corporate boards of directors as I began to get involved in all this was not a very high one. Actually, I quoted previously the comment I first heard from Murray Kempton about editorial writers, that their function was to come down from the hill after the battle was over and shoot the wounded. It seemed to me that is what the corporate directors did. It does seem to me from what I read and the conversations I have had that corporate directors on the whole taking their responsibilities more seriously than they used to, that there is less passivity that you more often hear of and read of corporate directors getting involved, and I think that is one of the advantages of this whole new regime. So I am feeling—I mean to say, in closing, Mr. Chairman, I am encouraged to have both of these men tell us that they have the authority under existing law to make those changes which most people would think would be a good idea to make it more flexible and less bur-

dense without compromising the mission, and I am encouraged by that. Thank you.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Louisiana, Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman. I appreciate your leadership in calling the hearing.

Chairman Cox, you made a couple of points in your opening statement. I just want to echo the significance of them in my opinion. One was with regard to the fact that regulatory costs don't come out of the executive's pocket; they ultimately come from the investor. And secondly, that the scope of or magnitude of the securities regulatory changes brought about by Sarbanes-Oxley was perhaps the largest change in structure since the 33, 34 Acts. Because of those two observations, I think we have an obligation to continue an ongoing oversight and examination. I don't know it to be the case, but I can maybe say it that, among those from the business community who have expressed 404-type language to me, it has not always been complimentary language in private conversation. It may be we need to have one of these hearings where we can get people to sit down and tell us what they think, but there is considerable angst even today about the expected ongoing implementation cost, not that I don't think that the Act itself is not justified in light of the circumstance when we consider. However, there are measures that might be taken I believe more aggressively to help with implementation costs, one of which is to encourage the utilization of regional or specialist accounting firms to come into compliance with 404 requirements. I believe that many in the marketplace feel that, unless they are dealing with one of the big firms, that is automatically going to be some sort of internal red flag when the audit committee does its work. However, within that context of the circumstance we faced at the time, the unfolding numerous accounting irregularities and corporate mismanagement, I feel that the Act was appropriate but that we are rounding a corner.

Again, Chairman Cox, I know you have been a strong advocate of promotion of data tagging or XBRL. It would seem to me that implementation of that standard of reporting for the public operating companies over some period of time would enable us to eliminate some of the duplicative difficulty as Mr. Frank was just making reference to FDICIA, and banks having to conform in perhaps conflict with 404 with the implementation of XBRL, the data can be provided once to all regulators in whatever format they choose and move away from the paper-based system to a more realtime material fact of disclosure. Secondly, the current system as modified by Sarbanes-Oxley is a retrospective rules-based system which I think coupled with the quarterly earnings pressures were the tools and the forces that brought about the Enrons and the WorldComs; that in order for sophisticated managers to be discreet every 90 days, they took that rule book and turned it on its edge. I believe I am correct in attributing to a number of FASB the view that we ought to consider moving more towards a principle-based accounting methodology as opposed to rules-based. If we were to do so in concert with the elimination of quarterly earnings reports together with technological reporting methodologies such as XBRL, I think we could take the next step in corporate accountability in

that appropriate investor protections are not mutually exclusive of professional business management. And I believe that we can enable having more transparent disclosure than we have now, not diminishing the responsibilities of management to disclose but do it in a fashion which actually results in a lower implementation cost for the industry that is now seeming to—well, not all together happy with the cost of compliance as it is now structured. I would just simply make that statement since I had the time to do it.

But my question is on another course, and that is with regard to the Fair Fund, another one of the significant elements I believe in Sarbanes-Oxley, which I believe today—and I don't have the recent information. I am sure that you would have better data than I, but I believe some \$7 billion or thereabouts had been identified as potentially available for recovery. About \$5 billion has been recovered to date, and by year end, I believe the actual amount returned to investors would be approaching \$3 billion. Are there any structural elements that you have concerns about the operation of the Fair Fund? And can you verify for me if those numbers are in the appropriate range of value at this point?

Mr. COX. You are correct on the numbers, I just wanted to check and make sure. In terms of distributions as opposed to what has been identified and made available for distribution, approximately \$770 million in Fair Funds has been distributed since the Sarbanes-Oxley Act gave the SEC that authority. This is new authority for us, and so we are learning how best to use it. The Commissioners, the five of us, all agreed that we want to do this as efficiently as possible because we spend a fair amount of time looking at the legislative intent, at, what your purpose was in authoring this provision.

Mr. BAKER. Any particular problems that need addressing?

Mr. COX. If you are asking if there are legislative problems, I don't think so. If you are asking whether there are problems that need addressing, the answer is yes. Not big problems, administrative problems, but our objective is to get this money out consistent with the statutory purpose much faster than would otherwise be possible. The whole point of the Fair Fund's authority is to wash out the litigation cost, to eliminate the rate cost that goes to private counsel and return all that money directly to injured investors with alacrity. So coming up with administrative procedures that permit us to do that rather than simply to replicate what private litigants would do anyway by following the same procedures or in some cases just piggybacking on their distributions in class actions is the challenge that is before us right now.

Mr. BAKER. Thank you. I yield back.

The CHAIRMAN. The gentleman yields back.

The gentleman from Pennsylvania, Mr. Kanjorski.

Mr. KANJORSKI. I would like to talk about the future a little bit. One of the complaints I often hear on the Street is that 19 of the largest 20 IPO's in the last year were undertaken in markets other than the American exchanges. This complaint seems to envelop into some of the questions as to whether or not the Sarbanes-Oxley Act disadvantages the American market from foreign markets for some international companies. With that idea in mind, from both of you, I would just like to know whether it is time that this com-

mittee, the American Government, and you as regulators, start to consider the creation of an international securities framework. Is it time that we recognize that the global market is here to stay and that perhaps we need to find some kind of methodology to allow money to flow freer with adequate protection to investors and transparency? Should we think about initiating some of these talks for international securities protection?

Mr. COX. The answer to that question is an unqualified yes. Indeed, I already commenced that process virtually a year ago when I first became Chairman. Events would have certainly driven the SEC to that even if we weren't clever enough to think of it on our own. There is no question, as you point out, that this exchange consolidation is underway. Beyond the LSE and your own acts, there may be other markets. It certainly stands to reason that, at some point in the future, people might want to offer as a competitive market advantage 24/7 trading which might imply 6 hours a day in four spots around the earth. Getting ahead of this potential business development by talking with our counterpart regulators in foreign countries, not just in Europe but around the world, is what the SEC is very busy doing right now. I have spent far more time talking to our counterpart regulators than probably past Chairmen have thought necessary for this reason. I have spent a lot of quality time with the FSA in the United Kingdom. I am going to be in Portugal next week to talk to the Euronext regulators. This is a top priority for the Commission.

Mr. OLSON. Congressman, a couple of reactions. First of all, let me go back to the IPO number that you talked about. Undoubtedly there was a point in time where that number was correct. As we have tried to look at the IPO market to try to measure the impact of Sarbanes-Oxley on the attractiveness of this market versus others, the most significant adjustment in the IPO market—for example, the United States versus the European market—occurred in the time from 1995 to 1999. That was a time when IPO issuance in the United States dropped significantly, while, in Europe, it increased significantly for reasons that I can't fully explain to you.

During the period immediately following the dot-com bust, there was a similarity in the movement of IPO issuance around the world with the exception of Northern Asia. In other words, markets tend to move in sequence, and there was a—and the movement there was quite similar. In the last few years, what has happened is that there has been an increase, the IPO market has increased to a greater extent in Europe than it has in the United States, but it has grown in the United States. So we—coming back to a point I made earlier, I think that it is important to evaluate over a longer timeframe what is happening in the markets and the impact of recent legislation. But let me—let me say in parallel to what Chairman Cox indicated, and coming back to the point that Congressman Baker made, among the other things that we see happening is a focus on international accounting standards, some of which is directed toward a more principle-based accounting. What we need to do as regulators is to assure that our manner of regulating and our manner of inspecting accommodates whatever changes take place in prudential accounting.

Mr. KANJORSKI. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired. The gentleman from New Jersey, Mr. Garrett.

Mr. GARRETT. Thank you, Mr. Chairman. Before I begin, let me just make a comment with regard to the ranking member's opening comments about some of the positive sides of what has occurred so far is that certain companies who are not under the auspices of what is being required are looking to see—implementing some of the same requirements under SOX which I guess just points to the fact that, in a free market situation, investors will go to those markets who are implementing transparency and the like. The flip side of that argument of course is that, in a free market economy, that without SOX in place, companies would go in that direction anyway and may be an indication that the free market would tend us to go in a direction of legislation that is pending. I think Congressman Flake has it that SOX should be totally voluntary, and the investor class is smart enough to decide where they want to invest their dollars. That really goes to the second point that the chairman made is that Congress acted, obviously, in the heat of the moment of what was going on after Enron and WorldCom came about and was responding to much of the political pressures that we were experiencing at the time. But I think we have to remember one thing back at that time is that the officials of both Enron and WorldCom broke laws that were in fact on the books at that time, and they were successfully prosecuted under those laws as well. And an indication of consumer or I should say investor confidence that can be seen in what happened with the Dow Jones after that. The Dow Jones Industrial Average actually rose after the disclosure of the Enron problems. I think that belies the notion that there was a breakdown in the investor confidence. On the other hand, I think it shows the investors were smart enough to react to the circumstances.

I would like to thank Chairman Olson for being here and just ask you a couple questions. I am concerned, as are outside organizations, with the constitutionality of the PCAOB and would appreciate your thoughts on whether or not Congress should be or could be exerting more control over the PCAOB, bring it under a control with regard to annual appropriation process, congressional oversight in addition to what we are doing here as far as the normal appointment process. The PCAOB is basically a de facto regulatory agency and therefore should be in line with all other constitutional principles. So, in your opinion, should members of the board be Presidential appointments with Senate confirmation just like any other regulatory board? And since PCAOB can and does collect fees, should they be treated for appropriation purposes the same way that the SEC occurs?

And finally, second portion of that, I would turn to Chairman Cox. One of the outside organizations that has filed suit is the Free Enterprise Fund challenging constitutionality on various points that I have raised here. The FCC apparently has joined with that suit, and the response that the FCC had is, in spite of filing a joint brief, is that they have broad and pervasive oversight with regard to PCAOB.

My question to Chairman Cox is, has there been any instances—and perhaps you can give them to us today, where you have used

that broad and pervasive oversight where the PCAOB has decided to take some sort of action and the FCC has used that oversight to stop them?

Mr. OLSON. You asked me the first part of the question, Congressman. That portion of the statute, title one, PCAOB is very carefully crafted. As I remember, the discussion at the time, the issue facing the Congress in creating an agency, an independent agency which would replace the self-regulatory agency was to create one that would attract the talent necessary to achieve the objective in a timeframe necessary for it to get up to speed for the purpose of achieving the congressional mandate, and I will submit that I have difficulty envisioning how it could have been done with any other type of a construct or any other type of an organization. And so I think it was carefully constructed as it was, and—but I will say also that one of the other elements that the Congress did add was that it provided for very significant—in fact the term we use is “pervasive oversight” by the SEC. And so there is this very significant element of oversight responsibility that the SEC has in fulfilling our mission, and you ask again also about the lawsuit and the constitutionality. Our internal counsel and our external counsel are very confident that the constitutionality of PCAOB will be upheld, but I will also turn it over to the chairman to answer further if he would choose.

Mr. GARRETT. Thank you.

Mr. COX. You asked me to address specifically the extent to which the SEC has exercised its oversight authority over the PCAOB, and I will just give a handful of examples in my experience in 1 year. First, as you might expect, given the range of PCAOB responsibilities, in order for that oversight to work, there has to be very close communication and coordination between the PCAOB and the SEC, and that starts at the chairman level. With Chairman McDonough, with acting Chairman Gradison and now with Chairman Olson, I have had a very close working relationship and an opportunity to discuss things in development so, before it is too late, before the SEC would have to take formal action after the fact to try and influence or adjust or reverse some action, these things are well understood and worked out to start with. Second, very formally we adopted a rule governing PCAOB budgets. The rule was crafted with the assistance of then acting Chairman Gradison, who had an awful lot of useful experience as ranking member of the Budget Committee here and member of the Ways and Means Committee for many years. He understands how the agency budget process works, and so the budget process that has now been adopted just a few months ago for the PCAOB is virtually the same that the SEC has, reporting to OMB and of course to the Congress. And we follow very similar deadlines so there is that passback process and so on. Before that rule was adopted, before the SEC exerted that oversight authority and exercised that responsibility, I would say that, from the SEC's standpoint and therefore from the public's standpoint, it was not a transparent process. With respect to 404 in particular, we have had concern about how AS 2 works. Every PCAOB auditing standard has to be approved by the SEC. And so what we are doing with AS 2 is anticipating the necessity of SEC approval for any rewrite of AS 2,

and we are just rolling up our sleeves and joining in this effort to make sure we get it right. We are inspecting, through the use of the SEC inspection process, the PCAOB inspectors this year to make sure that they are doing what we think they are doing, and that is trying to make the AS 2 implementation process more cost-effective. The PCAOB put out guidance in this area and we are trying to encourage that result. They are now in the process of inspecting the auditing firms to see whether they are implementing that guidance. As I noted, the SEC inspectors are going to inspect the PCAOB inspectors and that inspection process to make sure that is all working. In all of these ways, and I can provide other examples, I think, that the process that Congress asked us to follow is being utilized extensively.

The CHAIRMAN. The gentleman's time has expired. The gentlelady from New York, Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman, and welcome. I would like to follow up with the line of questioning of Mr. Frank, and I was glad to hear, Chairman Cox, hear you say to him that you thought the law gives you the ability to adjust Section 404. I must say, I hear practically every day from small companies in my district, and they really feel that the law is burdensome, costly and unfair to them, and they want an adjustment as soon as possible. As you know, there are several legislative ideas and legislation is before Congress now. So my question is, what is your timeframe for implementing this change? And what should we think of as your deadline? I am sure that will be the first question I am asked tomorrow by companies in my district.

Mr. Cox. In addition to the extensions that we have repeatedly provided for smaller public company compliance so that, to date, no smaller public company, properly defined, is required to comply with the 404, the roadmap that we announced in May of this year has as its major component a process that will enable the SEC to put out guidance for management that will be especially useful for smaller public companies. So they will have a framework in which to apply 404, and there will be a revised auditing standard, too, which heretofore has been almost the entirety of 404 guidance, and that, too, should address the needs of not just current company compliance but also of those smaller public companies which have not had to comply with Section 404. All of this is anticipated to be accomplished before the expiration of these latest extensions. If for any reason our work is not completed before the expiration of those extensions, then certainly the Commission would want to consider further extending, but our plan is to do it within that timetable.

Mrs. MALONEY. Okay. And that timetable is 3 months, 6 months?

Mr. Cox. Well, the extensions take us in one case through 2007 and the other through 2008, and so we expect, in order to stay within those respected deadlines, to do this in the first half of next year.

Mrs. MALONEY. There is also concern in Europe that Sarbanes-Oxley would apply to European companies if the European exchange they list on merges with a U.S. exchange. Even though you have said this is not the case, they still have this concern. And can you clarify it further? Again, I keep getting questions on it.

Mr. COX. Indeed. In fact, just this morning I got a report from our Office of International Affairs that our dialogue with European regulators has yielded substantial support for the statement that we issued, I believe it was in June, and we will continue to take every opportunity to repeat that clear message. National regulators will remain responsible for the regulation of the capital markets within their jurisdiction. And certainly the proposed transactions before us with respect to LSE and Euronext don't threaten that regime.

Mrs. MALONEY. Thank you. And I would like to hear your response to the claims by some that our markets have become less competitive because of Sarbanes-Oxley and, specifically, allegations that companies that would list on our exchange are now listing abroad. And how can we evaluate the significance of IPO's abroad? And should we be surprised that Russian and Chinese companies list on their home exchanges? Or is this a trend that is troublesome to American business, the fact that many companies have literally said, I won't list in America now because of this? Your comments.

Mr. COX. Well, I think the way you put the question with some nuance is very appropriate because oftentimes one hears a statistic about how many of the world's largest IPO's are taking place in the United States or on foreign markets. It is appropriate to take a look at the IPO's in specific, and you will then notice that several of them are state-owned companies that for a variety of reasons are going to prefer listing in their home markets or are going to prefer not to come to the United States. And whether or not such listings would meet U.S. standards is always a question that needs to be asked. On the other hand, fully half of the question has to be, what about the rest of these offerings? And should the United States be doing anything differently to make sure that we continue to attract capital here? We have the deepest, most liquid markets as is often repeated. Is that a birth right? Is that something that is necessary in nature? Probably not. So we have to have a constant focus on it and certainly at the SEC we do.

Mrs. MALONEY. Would these companies, Mr. Chairman, meet the tests of transparency and corporate governance that we require of American investors? And to what extent are other economic factors possibly responsible for this movement? And to what extent can we regain our competitive dominance without sacrificing our leadership on integrity and security? And lastly, if any way or any thoughts you may have on how we could evaluate the significance in a clear way of this movement or growth of IPO's abroad, and I, again, thank you both for your service and for being here today. Thank you. My time is up. But any response I would appreciate.

Mr. COX. I think, if you put the question in gross, that there are undoubtedly many companies that are public companies that are listed somewhere else in the world that would not meet our standards. There are also undoubtedly many companies listed elsewhere in the world not listed here in the United States that we would love to have listed here. Companies now have more choices of where to list. It is a more competitive capital market than it has ever been before, and the fact that there are other pools of capital is something that will cause the United States, I think, to sharpen its competitive edge. That is probably all to the good. There are

good reasons, given that there are choices that some companies might not choose to come to the United States even though they might have a premium for listing here, as has been shown in many academic studies. Those reasons might include wanting to be closer to their product markets which might not be in the United States. So it would never be the case that we will have all offerings here, but it has long been the case that we have had the lion's share of them, and I hope and expect that that will continue to be so. At the Securities and Exchange Commission, since a statutory mission that Congress has given us is the promotion of capital formation, we are doing everything that we can to make sure that the United States retains and sharpens its competitive edge.

The CHAIRMAN. The gentlelady's time has expired.

The gentleman from Texas, Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. And thank you for holding this hearing. I think it is an important part of our oversight to continue to monitor legislation that this Congress passes and make sure it is working for the purposes intended.

I appreciate Chairman Cox and Chairman Olson being here. The issue that I want to talk about is something that, Chairman Cox, that you brought up towards the end of your remarks, and that is about the issue that we have been reading in the paper about backdating stock options. And I am wondering if the correct terminology is, that should we be using, is effective dating? I know that a lot of companies today use various techniques in order to have meetings and to come to board actions. One of them might be to have a teleconference talking about when to make options effective and then following that up with a unanimous consent agreement that would be signed by all of the shareholders. I know that a study was done where over 200 companies actually used that practice of having a telephone conference following up certain board actions with unanimous consent agreements. One of the things I think is important is that, in this process, you know—and by the way these companies have all had audits by some of the major accounting firms, and that issue has not been brought up. And now, all of a sudden, this backdating issue is coming up, kind of wondering where the auditing firms have been in the SEC over the years where now this is coming forward, but more importantly, what are we going to do to ensure that where those companies that have gone back and tried to search and find the lowest share period for that and possibly commit a fraudulent act and those companies that are in their ordinary course of business or just transacting their business, how are we going to make sure that we have a way to ensure those companies that have been following the advice of their attorneys and other professionals that in fact what they have been doing is within the compliance with Sarbanes-Oxley and not have to worry about this new veil now overhanging people that are signing off on stock transactions? So Chairman Cox, could you kind of elaborate on that a little bit for me?

Mr. COX. Yes. In fact, your question permits me to give a very timely answer. Today, the Securities and Exchange Commission's Office of the Chief Accountant has published a staff interpretation of the accounting literature to provide guidance for companies that want to do the right thing, that want to stay in compliance and

then want to do so quickly. The SEC wants to make sure that companies are able to continue to put their financial statements out in real time. With the third quarter revenues and the September 30 deadline coming up, that all of that is timely, and we have a constant flow of good information to the marketplace. With respect to companies that have some people with black hearts that have cheated, we have another tool. That is our enforcement division, and we are bringing cases—some of them are now public—to make sure that everyone understands that, if your conduct is egregious, such as is alleged in these cases, there will be consequences. Now, since this is a Sarbanes-Oxley hearing, I can also repeat my retro-active congratulations to the Congress for having the presence and the foresight to include this real-time reporting provision because now the reporting of the grants has to be made within 2 business days, whereas before it was up to 45 days after the end of the fiscal year, so it might be more than a year later. The status quo ante Sarbanes-Oxley had that sort of attractive nuisance, that moral hazard that gave people the opportunity, if they had black hearts, to take advantage. That door has been slammed shut thanks to Sarbanes-Oxley.

Mr. OLSON. Congressman, in addition to the window being shut, a succession of changes in accounting have also made it less likely that there will be backdating. From a period of time where you could avoid expensing entirely, if it was an at-the-money grant or as opposed to an in-the-money grant to transition to 123 which allowed for a voluntary expensing to 123(r) where it is now mandatory. So that window is largely closed for the combination of the two reasons. We issued our guidance, however, because we just wanted to call attention to the existing literature that is out there regarding the audit issues that may come up having to do with options dating. But I suspect that the issue is largely behind us.

Mr. NEUGEBAUER. I just want to make sure that, for example, say today we got on a conference call and we decided to set the effective date for an option, and maybe 2 or 3 days transpire afterwards; someone is calling around polling board members for that, and then, in 2 weeks, where the UC agreement then begins to circulate around and get the last signature. I think we want to be clear about that, the fact that maybe the agreement was not—the UC agreement was not signed for 2 weeks, but the decision was made maybe today in making sure that we don't start to perceive that as some kind—some way in backdating transactions, and using some commonsense because what I have seen—and I know, Chairman Cox, your time in Congress, sometimes we spend a lot of time penalizing 99.9 percent of the people for the things that one-tenth of 1 percent of the people are doing. And I am just hopeful that you will work together with Chairman Olson and make sure that we use some commonsense as we look at these issues.

The CHAIRMAN. The gentleman's time has expired.

Mr. NEUGEBAUER. And not create additional problems for, you know, compliance with Sarbanes-Oxley.

The CHAIRMAN. The gentleman from North Carolina, Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman, and thank you for having this important hearing.

And thank you, Mr. Cox and Mr. Olson, for being here. One of the things I try to do sometimes at these hearings is, in addition to evaluating the impact of legislation that we passed and the effectiveness of the regulators at carrying that legislation out, is maybe use this as an occasion to evaluate ourselves and the way we do things in Congress. My impression is that we were a lot less micro-managing in Sarbanes-Oxley, for example, than we were in Gramm-Leach-Bliley in the sense that we set out some general principles and left it to the regulators, SEC and the accounting board to kind of put substance there as opposed to kind of legislating a group of things that we wanted carried out in Gramm-Leach-Bliley. Without implying any criticism of this, I am just trying to put this in a framework, what—what is the authority, for example, for the SEC under this statute to delay the application of Section 404 to smaller companies? I mean, I guess I am trying to figure out what the interplay is between the standard that Congress wrote, it said, you shall do—provide investors an assessment of their internal control. Didn't say when. Where is the authority of SEC to delay the implementation of that or the application of it to a particular set of business people?

Mr. COX. Well, I think you were right to parse the distinction between exemptive authority and interpretative authority that is being exercised in this case to phase in compliance. There is a much more difficult legal question that is under debate that I hope to obviate by not taking that course. Whether the SEC has exemptive authority that would permit it wholesale to exempt a class from compliance from the otherwise clear injunction.

Mr. WATT. Basically, what you are saying is you concede that if you were exempting smaller companies completely from Section 404, you would have to come back to Congress and get that authority, but you can delay the implementation of it without coming back for additional authority?

Mr. COX. Well, I think all I am prepared to opine on with respect to exemptive authority is that—I should say report on, because it is a fact—there are legal authorities who sharply disagree on both sides of that issue on whether or not the SEC has such authority, and indeed, Members of Congress who have communicated with us have communicated with us on both sides of that issue and thus placed themselves in sharp disagreement. The SEC is not going to test that. We are not going to use the exemptive authority that we might or might not have, but rather we are going to take the view that Section 404 can be made to work for issuers of all sizes.

Mr. WATT. I guess from my own perspective, I am trying to evaluate which one of these processes works better. The more aggressive legislating that we do, it seems to me that in that context, at least some people believe there is a greater need for us to go back and revisit some of the provisions of Gramm-Leach-Bliley, because we were micromanaging, than there is in this case to revisit immediately Sarbanes-Oxley because we delegated or seemed to give a lot more delegation to the regulators, SEC, to set some of these standards. Just comment for me a little bit on how you feel like this is operating in that general context.

Mr. COX. Well, I really enjoy being asked the question even though I am having a little difficulty answering it. Because, you

know, in my congressional mindset, I would like to think that Congress is completely competent to write very specific legislation that can be prescriptive where necessary, and that is probably a healthy way to do things rather than to leave it up for grabs and for somebody else to figure out. As a regulator now, I am also comfortable in saying that if Congress delegates to agencies with specialized expertise the obligation to fill in the blanks and the details that the agency can do an effective job of that as well. With respect to the very specific example you gave, Gramm-Leach-Bliley versus SOX, perhaps one of the reasons that you are getting people coming up here to the Hill saying, we have got to do something about Gramm-Leach-Bliley, is that this many years after the enactment of that law, we still haven't got rules. That is our responsibility as regulators. So I can tell this committee that I am busy working with the banking regulators to try to get agreements that we can put out finally, rules under Gramm-Leach-Bliley. It is, in my view, high time that that be done. Then, if there are still concerns, it would be appropriate either for the regulators to go back and fix those or for Congress to legislate again.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from North Carolina, Mr. McHenry.

Mr. MCHENRY. Thank you, Mr. Chairman.

I want to start today by referencing the ranking member's comments and, Chairman Cox, your to reply to that. FDICIA 1991, that largely, you know, that is largely the basis of Sarbanes-Oxley. When you are talking about banks, their internal controls are regulated under FDICIA by the Fed, FTC, ODS, FDIC, depending on the institution of course. You mentioned in your answer to the ranking member's question that perhaps small banks, those that are small bank holding companies perhaps that have one single bank within it, those are ones you would like to possibly look at relieving some of the burden under 404. Can you elaborate on that?

Mr. COX. Yes. What I was pointing out is that the Sarbanes-Oxley requirement in Section 404 applies to the bank holding company rather than to the bank, and if the bank holding company has anything in it besides one bank, then the rationale may not be there any longer to provide the proposed exemption, but that if one were talking about a one-bank holding company, then that is perhaps—

Mr. MCHENRY. Where are you in that process?

Mr. COX. To be honest with you, until very recently, I had not considered the idea. I have heard it is under consideration here in Congress. It is my tentative view, uneducated thus far by our general counsel in our operating division, that that might require some legislation because I don't know that we have the power to exempt bank holding companies from 404 compliance as a class.

Mr. MCHENRY. Could you, after speaking to your general counsel in a more substantive way, could you submit to the committee an analysis of that, whether or not that would be required?

Mr. COX. I would be pleased to do that. I would be very happy to do that.

Mr. MCHENRY. Thank you.

Chairman Olson, I want to commend you on your choice staff, hiring someone from North Carolina and a constituent, her father

remains a constituent of mine. I want to thank you so much for that. And having said that, but there is always a but, right? You mention that you saw—in regard to the same question that the ranking member—a significant overlap for small banks or banks in general and that you had a move within the PCAOB to significantly reduce that overlap. I have not seen that nor heard that from any of the bankers I have met and discussed with, nor have I heard it from the banking industry in general. Can you tell me what is happening, because I haven't heard it unless this has happened in the last few days?

Mr. OLSON. Well, first of all, the threshold requirement for FDICIA 112 is \$1 billion in asset size. So if—and the threshold requirement for a 404 or AS 2 has only to do with whether or not they are a public issuer. So you have a difference in the threshold requirement for the applicability. If they are a small institution, however, the financial reporting internal controls 404(a) and (b) still will not be effective as the chairman said, for some period of time. At this point in time, that benefit would apply to the accelerated filers. In other words, the large institutions, the large institution's in North Carolina for example.

Mr. MCHENRY. Certainly.

Mr. OLSON. So if you were to hear it to this point, you would be more apt to hear it from the largest institutions.

Mr. MCHENRY. I would like to say, you know, you both say that there perhaps hasn't been a chilling effect—

Mr. OLSON. I am sorry, Congressman. There hasn't been what?

Mr. MCHENRY. A chilling effect. My apologies. My accent may have gotten in the way there. Chilling, cold.

Mr. OLSON. Thanks to my work with your constituent, Congressman, I am starting to be able to understand the language very well.

Mr. MCHENRY. You might even use the word y'all.

Mr. OLSON. Yes.

Mr. MCHENRY. There has been—just looking at 2005 IPO's, 24 out of the 25 largest listed in other exchanges foreign to the United States. And you see just with the IPO's, 12 were Chinese companies, to your comment earlier, Chairman Cox, 12 were Chinese companies that qualified with the New York Stock Exchange but chose to list in other markets. The top 10, all of which were in foreign markets; I think we do see a chilling effect on this. And I would like—you know, I think that is an important thing to note in this hearing. So with that, I yield back.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Georgia.

Mr. SCOTT. Yes, thank you, Mr. Chairman.

Chairman Cox, the New York Stock Exchange and NASDAQ are merging or they are buying stakes in international exchanges. And some commentators, especially those in Europe, have suggested that if the U.S. exchange were to merge with—if they were to merge with a foreign exchange, then Sarbanes-Oxley would apply only to those companies listed on the foreign exchange. Now, this seems to me to be a clear misunderstanding of the law, the intention of Congress and the intention of Sarbanes-Oxley and the intention of the Securities and Exchange Commission. Do you agree

that Sarbanes-Oxley would not apply to companies that are not listed on a U.S. exchange, even in the event of such an international merger?

Mr. COX. Yes. Given the transactions that we are aware of thus far, that is undoubtedly going to be the case. And, as you know, the SEC has very publicly and clearly stated that. And we appreciate this opportunity to say it again.

Mr. SCOTT. All right.

Another question I have is, I am concerned about the competitive position of the United States in this increasingly global financial marketplace. We have all heard of the alarming statistic about the flight of global IPO listings to foreign markets. Many cite the high cost of compliance to Sarbanes-Oxley as one of the reasons for this trend. And I believe that there are costs that can be significantly reduced through regulatory action by you and by Chairman Olson. I am wondering if you agree with me on that. And if you do agree, if this is a priority with you.

Mr. COX. I do agree with you, and it is a priority. I often hear, as I am sure that you do, the combined costs of regulation and litigation in the United States do not compare favorably with competitor countries. To a certain extent, I think we want to have the benefits of our regulatory system and our civil justice system, so we are unwilling to give them up. But we also have to be very keenly aware that, if there are excessive costs in those systems, we need to wash them out. I am absolutely convinced that, in both the case of regulation and litigation, there are excessive costs that can be wrung out so that we can be more competitive. At the SEC, of course, we are responsible for the regulatory piece, and we are working very hard to reduce those unnecessary costs. In the context of this Sarbanes-Oxley hearing, certainly 404 is a good example where we had that opportunity. I think we will be successful.

Mr. SCOTT. Do we have any quantitative data on any loss of companies or moving out of it because of the high cost of complying with Sarbanes-Oxley?

Mr. COX. Well, we certainly have good quantitative data on where companies are choosing to list. Their motivations are a little harder to button down. Some companies are happy to announce what their intentions are. Others are a little bit more opaque about it. But I just think we have to be very eyes open and recognize that, leaving aside regulation, litigation and those costs, the capital markets are, for the betterment of our world and mankind, more competitive now than they have ever been before. There are more choices, and a lot of that is due to U.S. leadership because we have been promoting the concept of markets to countries around the world, and they are taking us up on it. So as developing countries and Europe and Asia, mature economies now, have deeper and more liquid capital markets than they used to, we are going to have people with choices. Getting back to first principles, if we believe in markets and the strength of competition to reduce costs and provide higher standards of living, then that is a good thing. We just need to compete in order to win, and competing means offering a better service, a better product at a lower price.

Mr. SCOTT. Let me ask you, going back to what I really think is the big elephant in the room of course is section 404. Most of the

complaints that I get within my constituency and the business community is that it is sort of like one size fits all. It is costing smaller companies a great amount of money. What recommendations would you make to that specific concern about the complaint from smaller businesses who feel that section 404 was basically written for these larger corporations and it is just costing them just an arm and a leg.

Mr. COX. I think the evidence on that point is overwhelming. The way that section 404 was implemented through Auditing Standard No. 2 initially was more expensive than anyone expected, and certainly that process would be unduly burdensome for smaller public companies, and that is why compliance for those companies has been postponed until we can get a framework in place that actually makes sense for smaller public companies.

The SEC appointed an advisory committee, as you know, on smaller public companies to look into this very carefully over a long period of time. They produced an excellent report, and they recommended to us an alternative: either exempt smaller public companies or postpone compliance until such time as there is a framework that is workable for implementation of Sarbanes-Oxley section 404 by these smaller entities. We have chosen the second prong of that recommendation. That is the road map that we laid out in May, and I think the stakes are very high. I think we have got to succeed in this effort.

The CHAIRMAN. The gentleman's time has expired. The gentleman from Alabama.

Mr. BACHUS. I thank the chairman.

Chairman Cox, yesterday in Chicago there was a town hall meeting by a capital markets commission and actually members of your staff and members of Chairman Olson's staff testified and what it dealt with was the legal risk facing private sector auditing and the resulting risk to the capital markets and to investors.

I will shorten the question to say they actually talked about the viability and the effectiveness of independent auditing at publicly held companies going forward and the legal risk. Could you comment on those legal risks? I know we mentioned it a little earlier in your dialogue with the gentleman from Georgia. I really see the accounting profession at legal risk. Would you comment?

Mr. COX. Yes. This is the bookend to the costs that companies are complaining of in their implementation of section 404. The auditing firms are concerned with two things: First, getting it right, and second, their own liability if they don't. To the extent that that liability system isn't working just right, to the extent that it is imposing unnecessary risk, then the resulting behavior is that the auditing firm for its own protection runs up costs at investor's expense.

Mr. BACHUS. But you do see the accounting industry at substantial legal risk today, don't you?

Mr. COX. There is no question. The fact that there are four large firms that do essentially all of the multinational work means that for purposes of a great deal of litigation they are viewed as the insurers of last resort or sometimes first resort.

Mr. BACHUS. Let me move on to reg show, naked short selling. I know there have been proposals to reign that in and you have got

two proposed rule changes I think pending. I want to talk to you about two other proposed rule changes and urge that you take a look at those, and I want to actually introduce into the record—we have a company, Movie Gallery, in Alabama which has basically been savaged by naked short selling and Bloomberg did about an 8-page article on naked short selling and they weren't too kind to the SEC in that article. So I want to ask you to take a look at that as you leave.

The CHAIRMAN. Without objection.

Mr. BACHUS. The two proposals, and I would like to introduce it, many, including the U.S. Chamber of Commerce, are calling for the SEC to require that the aggregate amount of sales be disclosed daily, and I would like you to take a look at the SEC doing that.

Second, it seems to me that the whole problem of failures to deliver that results from naked short selling would go away if the SEC goes back to the requirement of a pre-borrow. What are your thoughts on those? You may not want to go into that too much, but I would I'd like to get your thoughts on those two.

Mr. COX. I would be, first of all, very happy to look at what it is you are going to provide to us. Reg SHO is very much on our minds because we just completed a roundtable, the Commission's word for what you call a hearing here, last Friday, September 15th. It was very successful. It was focused on our Reg SHO pilot. It had a number of distinguished academic researchers. I participated in it as did other Commissioners, and the presentation was focused on how the price test such as Exchange Act rule 10(A)(1) and the former NASD rule 3350 affect liquidity, volatility and market efficiency.

The rule itself, as you know, is relatively new. It was adopted in June of 2004. We are considering amendments to it, and we are particularly concerned with the problem of naked short selling. So your proposals are very timely.

Mr. BACHUS. What I will do is I will just submit to you in writing maybe—I just want you to know that there is concern. I do have an Alabama corporation that has really been damaged by it.

My third question, and Ms. Maloney and others have referred to the competitive disadvantages to Sarbanes-Oxley. I think they are mainly section 404. I think they are definitely—what we are hearing particularly from people in financial services, where we are the global leader in providing financial services in the world, is that section 404, there are some negative implications, particularly when it comes to internal control.

My question to you is can these negative implications, which I think the SEC has acknowledged, can they significantly be reduced by regulatory action?

Mr. COX. I am of the view that they can, and, furthermore, I am spending a great deal of energy and effort to make sure that they are in fact reduced, that these costs are reduced. Any regulation is going to have some cost, and so, to the extent that there is anything called assessment of internal controls, there are going to be costs.

But I think it is possible to do this and, as I mentioned, many other countries are doing this. So it is not unique to the United States. I think it is possible to do this in a sensible way that gives

investors a lot of bang for their buck. What we don't want is for the whole effort to be focused on the tangential and the irrelevant. We need an instinct for the jugular rather than the capillary. We want a risk-based approach that focuses on what affects the financial statements, and we want it to be scalable so that smaller public companies have a way to comply without a great deal of question, and so they don't get whipsawed by a process built for much larger companies.

Mr. BACHUS. I would ask Chairman Olson, too, if he would like to comment on how we can address the regs. I am not arguing that Sarbanes-Oxley didn't have benefit but I think we all acknowledge that there are some concerns about our global—

Mr. OLSON. We acknowledge that there have been legitimate concerns and costs that have been—that are probably unwarranted. AS 2, which implements section 404 from our perspective, was passed in 2004. We can see immediately that there were procedures that were being done that were in excess of what we expected.

By 2005, my predecessors, who were very quick to try to evaluate those changes, were already making adjustments in AS 2 either by putting out a series of Q and A's or by some other issuances that talked about grading accounting firms on the efficiency as well as the effectiveness. And the amendments that we are proposing now will address exactly the question you are raising.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Missouri.

Mr. CLEAVER. Thank you, Mr. Chairman.

Mr. Cox, thank you for being here. In your statement on page 3 in the fourth paragraph you said the SEC will continue to work with other regulators around the world to encourage effective regulatory standards that encourage capital formation, job creation and economic growth while at the same time offering a high degree of investor protection.

What is the SEC doing; what are the steps, what is the work that is going on that is protecting the investor protection?

Mr. COX. The reason that this is a global undertaking is that there is global convergence. There is undoubtedly beyond even the exchange consolidations increasingly one global pool of capital into which all of the participants dip and it is very much a competition not just between and among nations but between and among firms who operate in all of these different countries.

As that market, that global market, takes shape, it is incumbent on us as regulators to talk about harmonizing our regulations to the maximum extent possible. So what I am doing, what the SEC is doing, is working with our counterpart regulators to take a look at the extent to which already their rules are somewhat alike in some respects to our rules, and, when we find those opportunities, we will see if we can't make our rules not just like one another but the same. Then, to the extent that we have different approaches but we are indifferent about which one to pick, we will try to harmonize in that respect.

Finally, we will have the hardest category, which is those that are fundamentally inconsistent. Already in Europe this exists. We have one common rule book, and then we have separate national

rule books. We have to work just as Europe is working through all those for the simple purpose of wringing out the extra cost of duplication and redundancy. Any time there is a rule that accomplishes an objective one way and another rule that accomplishes the same objective another way, you have got unnecessary cost, and we want to eliminate that.

Here at home we have an opportunity with the regulation of broker dealers and possibly exchanges to eliminate duplication as well, and we are focused there.

Mr. CLEAVER. I agree with you about the interconnectedness, the global economy, but I would question whether or not that does not require something more formal than discussion. When you look at what is going on, the current size of U.S. investments held by foreign entities is rising and if, for example, those companies are listed in the Euronext but find themselves exempt from Sarbanes-Oxley, isn't it quite possible and in fact somewhat likely that companies can get around Sarbanes-Oxley because they are going to interconnect with foreign-held companies. And we don't—as you have said in comments before, looking at a statement you made at the American Securitization Forum in New York where you pretty much assured the foreign markets that they are not going to be subjected to Sarbanes-Oxley. What protects the investor, what allows the investor to know that even though this is a global market, I can trust what is being reported even though the money is so—there is so much shadow over the money because it is going into France, French companies in business with a U.S. company?

Mr. COX. There are several issues that I think converge here in this discussion. One is the issue of regulatory arbitrage, which you have alluded to. That is a very real issue. Regulatory arbitrage from the standpoint of a regulator is a hazard. We don't want to create needless opportunities for that to occur, so instead the approach is to work with our counterpart regulators to eliminate those.

Second—

Mr. CLEAVER. When you say you work with, I guess that is the little spot of my concern.

Mr. COX. The way that we work with them, and this gets into the second point, is to focus on our national objectives. Even though there is a convergence of markets, there has been no similar convergence of national objectives, countries and regulators in these countries all have different interests. So what we want to do through these discussions when we work with our counterparts is to try and construct an understanding that we are maintaining high standards. At least among the developed countries and the large markets we would like to have a high standards world. America is clearly the leading high standard country in the world. Not only do we have the largest market but the highest standards. I think those things are not unrelated because confidence in markets is such an important reason for people to invest there. There will always be people who have different points of view about what level of regulation to maintain and people who take advantage of opportunities for regulatory arbitrage. So what we have to construct is something that permits us to the maximum extent pos-

sible to protect U.S. investors and also to compete and to have our share of that global capital market.

The CHAIRMAN. The gentleman's time has expired. The gentleman from Florida, Mr. Feeney.

Mr. FEENEY. Thank you, Mr. Chairman, and thank you Chairman Cox and Chairman Olson. I want to join with the chorus of folks that have told you that much of my experience in talking to the business community is that Sarbanes-Oxley has had an enormous beneficial impact in terms of transparency, in terms of clearing up some conflict of issue rules and some corporate governance issues. Section 404 is really the heart of the matter and we are talking about cost/benefit analysis. And Chairman Cox, you just referred to regulatory arbitrage as sort of a sinister term, people avoiding legitimate regulations, but at some point we have to ask ourselves rather than redundant or superfluous regulations that are encouraging capital to flee public markets in America is really having all the advantages in the cost/benefit analysis.

I think both of you acknowledged that there was ambiguity and some confusion, I think is the word Chairman Olson used in the initial implementation, and I agree by the way that most of what is wrong with 404 can be fixed from a regulatory perspective.

But between the ambiguity in terms of how to comply with 404 and the death penalty in terms of civil penalties, criminal penalties for internal, external auditors, members of the board, CFOs, CEOs, we have sort of had this race to the regulatory extreme and it is a huge concern to the companies that I talk to. One of the things that I did not get a lot of in your testimony that I would be very interested in are some more details in terms of quantifying the cost because if we are going to do a cost/benefit analysis we need to know what those costs are.

I think in the original testimony in front of the Senate the SEC suggested 404 compliance would cost the average American company about \$92,000, I think was the estimate. In fact it has been, according to some estimates, about 30 times that.

I think we ought to talk about what the actual experience has been for the companies that have had to comply. I think it would be important if you could give us some detailed information about the percentage growth in private equity markets in America. But these are markets that are less transparent, less accessible to small investors like myself that have 401Ks or IRAs, and yes, the public exchanges are growing but are they growing as fast as the private equity markets and what effect does it have on the American capital system if we are going to have more capital raised in the private equity market as opposed to public markets? It tends to be more expensive, less transparent.

I think the percentage of America's lead in terms of the world capital markets has diminished. The last figure I saw shows over the last 4 years we have gone from roughly 44, 43 percent of world capital public market to about 38 share, and that has probably continued to decline based on all of the evidence that I am hearing.

Chairman Cox, I don't know whether you will respond to the study by Mr. Butler from the Brookings Institute and Mr. Ribstein of the University of Illinois where they suggested that while the direct costs of Sarbanes-Oxley are much higher than anticipated, the

indirect costs, and they admit it is a back of the envelope calculation, about \$1.1 trillion in terms of annual regulatory burden on the U.S. economy.

I would grant if there is a hundred economists that do this study we would get a hundred different answers, but if these guys are even close, this is having a huge impact on us.

Finally, the number of restatements have dramatically increased. We had something on the order of 1,200 restatements last year. How many were really material in terms of affecting investor behavior? Are some of these restatements unnecessary or redundant and are they adding to the expenses of compliance?

Finally, and I will end up and let you comment on what I have said. I really would be interested in some more quantitative analysis of the costs if we are going to do a cost/benefit analysis. I would ask you to address a couple things. Chairman Oxley alluded to the fact we have created what I call a quadropoly. There is really only four big accounting firms that are in the business of doing the internal and external audits and that has had some significant impact on companies trying to comply because they have very few, if any, choices.

The second thing is, as much as Mr. Olson suggests, we are trying to clarify 404, we do that almost every year and there is still a great deal of mystery in the real world about how to comply. What would be wrong with going to a de minimis standard of what is a material breach; for example, the old standard of 5 percent or less of gross sales or revenue for a year? Anything under that would be considered a de minimis or an error that is not a material impact on the very health of the company itself.

If you would comment on some of those suggestions. Finally, the Small Business Advisory Committee, Mr. Cox, did suggest that maybe random external audits every third year, fifth year might be a way to alleviate some of the costs. If you could comment on those suggestions.

Mr. COX. That last part you mentioned is with respect to 404, right?

Mr. FEENEY. That is right.

Mr. COX. I hope I made good notes, and I get to most of your questions. I will try and go through them as quickly as I can. First, with respect to the costs of implementation, there is no question that everybody got it wrong. Congress got it wrong, the SEC got it wrong. I described some of the reasons I think that was so. But the estimates that were provided were low-balled substantially, and there are a number of competing studies about what the numbers are, and while it is interesting to debate which number is most accurate, the remedy in all cases is the same.

To the extent that the regulation and the law are producing unnecessarily high costs, we need to get rid of those costs, and that is what we have set about doing. The indirect costs, such as in one of the studies that you mentioned, typically include such things as delayed time to market. A company, it might be a venture company, mid-stage growth company, ready to go to an IPO, delays its profitability because of extra regulatory or litigation costs, and when you add that all up for the country it gets you into the trillion dollar plus neighborhood.

I don't think there is much question whether that figure is exactly right or not; there are real costs associated with the civil justice system and with our system of securities regulation, and so the job always is to balance those costs against what we are getting for our money, and I think we can do better in both areas.

Our lead vis-a-vis the rest of the world in global capital markets is not something we can take for granted, and you are right, it is possible to use the term "regulatory arbitrage" in a nonpejorative way. I was using it a moment ago to describe what as regulators we seek to avoid. But it is also the case that people have choices, and if any country has burdensome regulations that aren't matched with any benefit, then people will put their money elsewhere.

So we need to recognize what it is that makes America's market so attractive. It is our rule of law, surely. It is the confidence that investors have that their money will be safe here, and some of that is attributable to our regulatory regime. That doesn't mean every regulation we can think of helps us be competitive. So we have got to distinguish between one and the other and get rid of all the extra costs because investors are paying for that. It is the investors' money, nobody else's money.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Alabama and our final member, Mr. Davis.

Mr. DAVIS OF ALABAMA. Thank you, Mr. Chairman. Gentlemen, most of the questions today have obviously, and it has been a fairly bipartisan course, most of the questions have been an effort to draw you out on the question of whether Sarbanes-Oxley has had a particularly pernicious anticompetitive affect. But what I want to do is spend a little bit of time perhaps providing another perspective on this.

My friend from Florida, Mr. Feeney, mentioned the costs from 404 in particular have been estimated at perhaps \$92,000 per American company. As I understand it, the market value of public companies in the United States is somewhere around \$16 trillion. As I understand it, over the last—well, just looking at 2005, there were 210 initial public offerings in the United States and approximately \$33 billion in capital raised off of those offerings.

I could go on and on and I have no idea whether you all know the average profit margins of companies who trade on our stock exchanges but the number 92,000, even if you are generous, if you triple it as Mr. Feeney wanted to do, that strikes me as for the overwhelming majority of American companies a fractional impact. Am I wrong to view it that way?

Mr. COX. I think Mr. Feeney's point was not that it was triple but that it was in orders of magnitude larger, perhaps. I think your point though is a good one. It is the fact that a regulation costs money can't be the end of the analysis. It is compared to what benefit? And in exchange for what? So it is very clear from the fact that section 404 exists in the law that Congress anticipated it would cost something. It is also very clear Congress wanted the benefit.

Mr. DAVIS OF ALABAMA. Let me ask another follow-up that flows from that. It seems that the largest dispute that Congress has is not whether there have been unfortunate regulatory costs during the life of Sarbanes-Oxley but whether or not the regulators can be

trusted to minimize those costs or the congressional oversight or congressional intervention is somehow necessary.

Mr. Cox, you served here for a period of time. In your experience was Congress particularly adept or skilled at providing clear guidance in terms of regulations and did Congress consistently do a better job of providing clarity than the regulator involved?

Mr. Cox. In my experience Congress uniformly did an outstanding job.

Mr. DAVIS OF ALABAMA. But, serious question, is there any particular reason to think that if Congress were to be very aggressively involved in reinterpreting or redefining 404 or any of the obligations of Sarbanes-Oxley, is there any particular empirical reason to think Congress is likely to be more efficient or more effective than say you at the SEC.

Mr. COX. Taking your question dead seriously, not only is it reasonable to expect the regulators to take that ball and run with it, I think there is an ample blueprint in 404 to get the job done properly. But also with 404 there was a legislative antecedent so Congress was not inventing from scratch in the case of section 404 and there was every reason to think that the regulatory follow-through would bear some distinct relation to its antecedent in FDICIA. It has not. I think we can do a much better job there, and we are very determined to do so.

Mr. DAVIS OF ALABAMA. Let me ask another question. Both of you gave for lack of a better term nuanced answers about the anti-competitive impact of Sarbanes-Oxley. I think, Chairman Cox, you pointed out that there are a variety of factors, for example, that might explain the surge in European and Asian IPO's as compared to American IPO's. You mentioned the state-based nature of a lot of the new public offerings, you mentioned genuine market forces that might have nothing to do with regulation, and then in the context of regulation you mentioned the overall backdrop of the American economy, the fact that way beyond Sarbanes-Oxley we have a variety of tax laws and regulatory structures. And finally, you mentioned in some instances there is a class of companies who prefer less transparency, which is obviously not an American value.

What is the best empirical case that Sarbanes-Oxley and section 404, as we are currently interpreting it, is having an anticompetitive impact on our capital markets?

Mr. COX. Even though you didn't invite me to do so, I am going to answer that question directly. But I want to couple it with a restatement of what I mentioned earlier, and that is that we have concluded that the SEC, after careful evaluation of the first two full reporting cycles, that this compliance has benefits. So as I talk about the costs and some of the consequences we don't like, I want to underscore that.

But getting directly to your question of anticompetitive effects, the best evidence is probably the least reliable from a social science standpoint. It is the testimonial evidence of people involved in the markets. It is not quantitative; it is subjective; but it is oft repeated and comes not only from market participants in this country but from around the world. We have had occasion to provide the forum for these comments at SEC roundtables. We have also participated in international events here and overseas. And of course

we have daily intercourse with market participants as a result of our oversight responsibilities, and in all of these ways it has become abundantly clear that market participants are making this claim.

The CHAIRMAN. One more?

Mr. DAVIS OF ALABAMA. One quick one, Mr. Chairman. The only thing that is unusual about that and somewhat troubling to me, Mr. Cox, is the collection of all the anecdotal evidence in the world is often not powerful for a very simple reason. If there were a strong anticompetitive impact, it would seem there should be some quantitative evidence that is not capable of being sorted out but some direct quantitative evidence that can be linked directly to Sarbanes-Oxley. And that is my only observation today. I have heard the anecdotes, as you have; I have heard the opinions of my colleagues. I am still searching somewhere for some specific evidence of anticompetitive impact by 404 as we interpret it today, and what I hear today is frankly more anecdote than specifics, but that is not your fault.

Mr. COX. I should add I didn't mean to imply with my answer, because I took your question very literally: what is the best evidence? I didn't mean to imply that there isn't quantitative evidence as well; there is. The quantitative evidence most frequently cited today in this hearing was IPO's. That is probably datum selected because for seasoned issuers, for companies already listed on the exchange, it is a little more cumbersome to delist, to go elsewhere and so on. The election one makes where to list in the first instance is a much more flexible choice. What one makes of those arguments, and there are different ways of presenting it, is again a subjective thing, however, and that data is susceptible to a variety of interpretations. But I think there certainly is some quantitative data that would support claims that section 404 has imposed undesirable costs.

The CHAIRMAN. The gentleman's time has expired.

The Chair would wish to thank both Chairmen for what I think the members agree would be a most instructive and helpful final hearing for this committee and to get all of the issues out on the table regarding the Act and, more importantly, your concerted efforts and positive input in making this Act work for our capital markets, and for that we are most grateful.

The committee is adjourned.

[Whereupon, at 4:48 p.m., the hearing was adjourned.]



## **A P P E N D I X**

September 19, 2006

**Opening Statement****Chairman Michael G. Oxley  
Committee on Financial Services**

**Sarbanes-Oxley at Four:  
Protecting Investors and Strengthening the Markets  
September 19, 2006**

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Good afternoon. This will likely be my final time to chair the Financial Services Committee and the subject is most appropriate: The Sarbanes-Oxley Act. Although it is named for two chairmen, it is the product of our legislative process. Senator Sarbanes and I have received both credit and blame in approximately equal doses. Nonetheless, Sarbanes-Oxley was necessary given the sustained damage both to our capital markets and to individual investors.

The day I took office on July 21, 1981, Americans were faced with sky-rocketing inflation and an Israeli-Lebanese conflict. Then-Federal Reserve Chairman Paul Volcker testified that day before the House Banking Committee, "Dealing with inflation is essential to our future well-being as a nation." The Dow Jones Industrial Average closed at 934, the S&P 500 at 128. At that time, 6.9 million households invested in mutual funds. Mutual funds had total assets of \$241 billion.

Since that day, the American investor and our capital markets have weathered many events: the insider trading scandals and the savings and loan debacle in the mid and late 80s, the deflation of the internet and telecom bubbles, the 9/11 terrorist attacks.

And perhaps the most daunting crisis for the American investor: the largest corporate scandals in American history in the inaugural years of this century. Congress's response to these scandals was the Sarbanes-Oxley Act, signed into law on July 30, 2002. With this legislation, Congress set about restoring investor confidence in our capital markets by strengthening the financial reporting and generally raising the bar at our public companies.

Nearly every provision in the Act can be tied to improving the accuracy and reliability of corporate disclosures, which is the heart of the federal securities laws. Sarbanes-Oxley requires more timely and complete disclosure of material information and underscores the duties of the individuals and entities monitoring financial reporting, from management and boards of directors to audit committees and auditors.

I believe the Act has been a success. More Americans than ever are invested in the market: over 53 million households own mutual funds, a nearly nine-fold increase from my first day on the job. Americans now have \$9.5 trillion invested in

mutual funds, 35 times as much as in 1981. Today, the Dow Jones Industrial Average and S&P 500 are near their all-time highs.

The Act, though, is still in its implementation stage, in particular for the most criticized of the provisions, Section 404, requiring management's report on internal controls and an auditor's assessment of this report. I must note that Section 404 was not in the original House-passed bill. So maligned is this provision that some are using it to try to impede the New York Stock Exchange-Euronext merger or to try to disrupt other potential cross-border exchange transactions, claiming that the Act will apply to companies listed solely in Europe, a claim that is false. Sarbanes-Oxley always has applied only to companies listed in the United States.

Ironically, Section 404, surely the most costly provision from the company's perspective, may be one of the most beneficial to investors. Companies—the board of directors, audit committees, management—are more engaged in ensuring a proper system of internal controls over financial reporting. In a Corporate Board Member survey, 81 percent of senior executives report Section 404 compliance as a success and 76 percent of senior executives believe Section 404 compliance has motivated improved internal controls. Stronger financial reporting benefits investors and improved accounting transparency fortifies our capital markets.

That being said, Section 404 has proved costlier than originally anticipated. I continue to believe these costs are due, not to the text of the Sarbanes-Oxley Act, but to an overzealous implementation of these internal control provisions.

I commend our witnesses today, Christopher Cox, our former colleague and Chairman of the Securities and Exchange Commission, and Mark Olson, Chairman of the Public Company Accounting Oversight Board, for leading efforts in making this implementation effective and cost-efficient. I support their bold intentions to revise Auditing Standard No. 2 to provide further implementation guidance to public companies and their auditors.

I look forward to hearing their views on these efforts as well as the impact of Sarbanes-Oxley on investor confidence.

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U.S. Congresswoman

# Ginny Brown-Waite

*Representing Citrus, Hernando, Lake, Levy,  
Marion, Pasco, Polk, and Sumter Counties*



## Statement for the Record Committee on Financial Services

"Sarbanes-Oxley at Four: Protecting Investors and Strengthening the Markets."

September 19, 2006

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Mr. Chairman, I want to thank you for holding this hearing today. The passage of Sarbanes-Oxley provided investors the confidence that diminished drastically in the wake of several corporate scandals. There is no doubt that Americans are better off since the passage of Sarbanes-Oxley.

However, I continually hear from small businesses that some portions of Sarbanes-Oxley, specifically Section 404, go too far. And I know I am not alone in hearing these complaints. The reporting requirements we have placed on these small businesses because of the activities of a few criminals are causing problems nationwide.

In working to deter future corporate scandals that could eat up the retirement plans of so many hard working Americans, I want to ensure that Congress did not over correct the problem. I look forward to hearing from the witnesses here today.

Again, thank you Mr. Chairman for holding this hearing.

STATEMENT OF THE HONORABLE WM. LACY CLAY Before  
The Committee on Financial Services  
“Sarbanes-Oxley at Four: Protecting Investors and Strengthening the Markets”  
September 19, 2006

Good afternoon Chairman Oxley, Ranking Member Frank, Members of the Committee and Witnesses, Chairman Cox and the Honorable Mr. Olson.

We meet today to evaluate the Sarbanes-Oxley Act at four years old. I can remember the market climate that necessitated this legislation. It was a period of market distrust, both with national and international investors. This was the time of Enron and World Com and highly publicized corporate collapses resulting in the loss of pensions for thousands of American workers, drastic devaluing of investors' stocks and widespread market instability.

Sarbanes-Oxley brought in reforms to corporate governance rules that created new standards for accounting and reporting. It created the Public Company Accounting Oversight Board (PCAOB) with a mandate that included oversight of inspecting and registering all accounting firms that audited public companies. The PCAOB adopted standards of auditing, ethics, quality control, and other standards relating to the preparation of public company audit reports. This contributed heavily to the return of investor confidence to our markets and the overall stabilizing of the markets.

There has been a great deal of discussion in Europe recently in connection with potential transatlantic market mergers concerning the applicability of Sarbanes-Oxley and other US regulations to companies listed on foreign markets. Officials at the SEC have made it clear that Sarbanes-Oxley does not apply extraterritorially to companies listed on foreign markets and it was clearly not Congress' intent to apply SOX extraterritorially. This is true whether those foreign markets are owned by US markets or not. Sarbanes-Oxley is meant to apply to companies listed on US markets only and need not be a part of the discussion of the proposed mergers.

We have come a long ways in these four years, but not without realizing that we do not have a perfect system. We know that we have to tinker with Section 404 and some other issues in Sarbanes Oxley. However, we must not use this evaluation to try to rid ourselves of Sarbanes-Oxley or blame Sarbanes Oxley for everything wrong in the world's financial systems.

We have a better business/investment climate because of Sarbanes Oxley. Let us focus on those areas that are truly in need of fine tuning and clearly within the mandates of the Act.

**Congressman Garrett Testimony for SOX Hearing 9/19/06**

Thank you, Mr. Chairman, for holding this important hearing. I know that you have invested countless hours into this issue and this legislation. I am grateful for all you have done to address investor confidence in our markets and to ensure that honest, forthright American businesses are not penalized for the transgressions of a few bad actors.

I would also like to thank SEC Chairman Cox and PCAOB Chairman Olson for appearing here today. I would like to note that staff in both of your offices have been very helpful to me and to my staff in navigating the provisions and requirements of Sarbanes-Oxley.

Four years ago, in the wake of massive accounting scandals at firms like Enron and WorldCom, two of America's largest publicly listed companies, Congress enacted the Sarbanes-Oxley Act (SOX). The intent of the Act was to restore investor confidence in our markets through greater accountability and disclosure – a worthy goal and I commend my Chairman for taking on this Herculean task. But, where I part ways somewhat with you, Mr. Chairman, is my assessment of the unintended consequences of SOX. Regrettably, the Act has had the unintended effect of creating undue—and often unbearable—burdens on small, honestly-run businesses.

It is diverting valuable resources away from other legitimate business needs; creating massive and tedious documentation requirements; and discouraging the public listing of both international and domestic companies on U.S. markets. Honest companies are being punished and the U.S. economy is having to carry the weight.

Officials at both Enron and Worldcom broke laws already on the books and were successfully prosecuted under existing law. And, one glance at the Dow Industrial Average, which actually rose after disclosure of the Enron problems, belies the notion that investor confidence in U.S. markets was particularly undermined or eroded by these scandals.

The part of the Act that is causing the most trouble for our nation's small businesses is Section 404, which sets rigid requirements for internal control structure and procedures for extensive financial reporting and assessment. In fact, 9 out of 10 complaints about SOX are related to this section. Even before SOX, companies understood that integrity in accounting fosters greater trust in the marketplace and, in turn, more profits, and they were acting to weed out fraud and slipshod accounting. The extra requirements of this section pile on significant additional costs. Section 404 adds external consulting costs, including legal fees, and substantially increases the audit and attestation fees for these companies.

I know both the SEC and PCAOB are working diligently to craft new guidelines to ease this tremendous burden on small businesses. I look forward to hearing from Chairman Cox and Chairman Olson directly about how these revisions are progressing and what feedback and input they have been receiving from the private sector.

When businesses have been conducting their affairs within the confines of pre-SOX law and acting with integrity it is reflected in the trust of their shareholders and the strength of the market. There is a place for Federal oversight, but the weighty burden of Section 404 is slowly strangling small businesses and our domestic markets. Thank you, Mr. Chairman. I regret that you will be retiring at the end of this year and will not be leading our efforts to fine tune your landmark legislation. I am hopeful, however, that myself and your other colleagues will be able to live up to the high standard of excellence you have set for us and that any refinements will reflect the spirit of your leadership. I yield back.

**Opening Statement****Congressman Paul E. Gillmor (R-OH)****Committee on Financial Services****September 19, 2006**

***Hearing entitled:*** "Sarbanes-Oxley at Four: Protecting Investors and Strengthening the Markets."

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Thank you, Mr. Chairman, for calling this important hearing today. I'd also like to thank Chairman Oxley for his extraordinary service to our financial markets, this Congress and the great state of Ohio. He will be sorely missed.

As has often been mentioned, Sarbanes-Oxley was the most sweeping reform of our nation's security laws in over 70 years and it is critically important that during the first few years of this Act's implementation, the Congress remains committed to strong oversight. I believe Chairman Oxley and Chairman Baker have done yeoman's work in ensuring adequate opportunities for Members of the Committee to ask questions of the regulators.

Earlier this year I had the opportunity to visit both the Nasdaq and the New York Stock Exchange. During my time in New York, I often heard the concerns of Wall Street that without a relaxation of Section 404, our markets may be in danger of losing their status as the deepest and most properly regulated in the world. While I believe that both Chairman Cox and Chairman Olson are taking the right steps to address the concerns of both Wall Street and the larger business community, I hope that this Committee will also tread lightly when making modifications to the underlying concepts of Sarbanes-Oxley of which I am strongly supportive of.

In addition to ensuring that our home-grown businesses have access to the capital markets, it is important that our markets remain competitive internationally. It is heartening that our markets are doing just. Recent news reports show that both Nasdaq and the NYSE are committed to competing in the current round of market consolidation. I understand that some foreign competitors point to Sarbanes-Oxley as a primary reason for foreign firms to avoid the U.S. markets.

This is simply a misstatement of the effect of Sarbanes-Oxley on foreign companies. Sarbanes-Oxley does not apply to companies that are not listed on U.S. exchanges, and will not apply to such companies in the event of a merger between a U.S. market and a foreign one. On the contrary, a merger between a U.S. market and a non-U.S. market will enable those markets to continue to operate under their own domestic laws, while expanding economic opportunities for parties in both markets.

I look forward to hearing from both Chairman Olson and Chairman Cox on year four of the implementation of Sarbanes-Oxley and to working with my colleagues on this Committee to ensure that our capital markets remain the envy of the world.

**OPENING REMARKS OF THE HONORABLE RUBEN HINOJOSA  
HOUSE COMMITTEE ON FINANCIAL SERVICES  
“SARBANES-OXLEY AT FOUR:  
PROTECTING INVESTORS AND STRENGTHENING THE  
MARKETS”**

**SEPTEMBER 19, 2006**

Chairman Oxley and Ranking Member Frank,

I want to express my sincere appreciation for you holding this very important and timely hearing.

Over the past decade, many have indicated that the U.S. continues to lose market share to its overseas counterparts. We have all heard the alarming statistic about the flight of the largest global IPO listings to foreign markets. Many cite the high costs of compliance with Sarbanes-Oxley as one of the causes for this flight.

It has become increasingly important for U.S. entities, in particular the U.S exchanges, to collaborate with their overseas counterparts. This collaboration is necessary to maintain the competitiveness of the U.S. capital markets in an increasingly global marketplace.

Both the New York Stock Exchange and NASDAQ are merging or buying stakes in international exchanges. Some commentators, especially in Europe, have suggested that if a US exchange were to merge with a foreign exchange, Sarbanes-Oxley would apply to the companies listed on a foreign exchange. This seems to be a clear misunderstanding of the law, or the intent of Congress, and of the intention of the SEC.

In reality, Sarbanes-Oxley would apply only to companies that are listed on a U.S. exchange even if the New York Stock Exchange-Euronext merger were to go through. As SEC Commissioner Atkins has noted, “foreign issuers whose shares are quoted only in Europe will not be subject to American regulation,” and as SEC Commissioner Nazareth has stated “Sarbanes-Oxley would not apply to any market not registered in the U.S., nor would it apply to companies listed on that non-U.S. market.”

Each of the markets of the New York Stock Exchange and Euronext will continue to be regulated in accordance with local requirements. Specifically, NYSE Euronext’s European markets will continue to be regulated by their existing regulators, and the SEC will continue to regulate the U.S. markets.

Mr. Chairman, at this juncture in the globalization of the financial services arena, we need to think both globally and locally if our markets are to remain competitive. In light of all the competition that the United States’ capital markets now face from their European and Asian counterparts, I cannot stress just how important it is that we move forward with the merger between the NYSE and Euronext and that NASDAQ be allowed to increase its market share overseas in order for it to continue to be able to compete.

Mr. Chairman, I yield back the remainder of my time.

**OPENING STATEMENT OF  
CONGRESSMAN PAUL E. KANJORSKI  
COMMITTEE ON FINANCIAL SERVICES  
HEARING ON SARBANES-OXLEY AT FOUR:  
PROTECTING INVESTORS AND STRENGTHENING THE MARKETS  
TUESDAY, SEPTEMBER 19, 2006**

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Mr. Chairman, just over four years ago after a tidal wave of corporate scandals, we adopted the Sarbanes-Oxley Act. We are meeting today to review the effects of this landmark law on our capital markets. I believe that it has strengthened corporate responsibility, improved auditing results, and enhanced investor confidence.

Since the enactment of the Sarbanes-Oxley Act, however, we have regularly heard complaints from some parties about the costs of complying with the law. In particular, the statute's provisions regarding internal control audits have become the subject of an extensive public debate. I would therefore like to focus my comments this afternoon on this area of the law.

We designed Section 404 to require publicly traded companies and their auditors to assess a firm's policies, practices, systems and procedures to prevent abuse, protect against fraud, and ensure proper accounting. This provision also requires companies to report any material weaknesses in these internal controls -- and work to fix these problems -- before financial reporting failures occur. This mandate helps public corporations to decrease their risk of future shareholder losses.

As I noted last year when we reviewed these matters, Section 404 has another important benefit: This provision is helping executives to better understand the financial reporting shortcomings within their companies, allowing them to recognize the nature of the problems earlier and adopt reforms in accounting procedures expeditiously. This work is also helping to provide important assurances to the senior officers of public companies who now must sign statements attesting to the accuracy of their financial statements under Section 302 of the Sarbanes-Oxley Act.

In May, the Public Company Accounting Oversight Board and the Securities and Exchange Commission announced the steps that they would take to improve the implementation of Section 404, particularly for small public companies. Hopefully, these efforts will result in the establishment of a "roadmap" that provides smaller companies and their auditors with the tools needed to achieve the benefits of strong internal control without unnecessary cost.

In addition to addressing questions about Section 404 implementation, I hope that our distinguished witnesses will examine another budding issue: how the Sarbanes-Oxley Act affects listed companies when an American exchange, like the New York Stock Exchange or NASDAQ, purchases or merges with a foreign one. I would also like to know the thoughts of our expert witnesses about what reforms, if any, we should adopt to protect investors in our increasingly interconnected international capital markets. Is it, for example, timely to consider the creation of an international securities framework?

In closing, Mr. Chairman, today's hearing is a fitting way to end your congressional career. As the Public Company Accounting Oversight Board and the Securities and Exchange Commission work to implement the law that bears your name, it is appropriate for us to review their progress.

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Opening Remarks

Representative Maxine Waters D-35<sup>th</sup> CA

House Committee on Financial Services

Hearing, “Sarbanes-Oxley at Four: Protecting Investors and Strengthening the Markets”

September 19, 2006

Good afternoon ladies and gentlemen. I want to thank Chairman Oxley for holding today's hearing on Sarbanes-Oxley. Indeed, Sarbanes-Oxley is a testament to the distinguished record of our Chairman. His dedication and commitment to restoring faith in our financial markets by protecting investors and strengthening the markets is symbolic of his record in the Congress.

This hearing represents an important milestone. It has been four years since Congress enacted Sarbanes-Oxley in the wake of the largest corporate scandal we had ever witnessed – WorldCom and Enron. The major element in most of the failures of U.S. corporations during this period was related to accounting irregularities and flawed corporate reporting. Sarbanes-Oxley is credited with imposing discipline to the way U.S. businesses are now required to conduct their affairs. Of particular importance is the means by which U. S corporations are now required to disclose financial information and report to the public.

Sarbanes-Oxley is now part of the American business lexicon. In board rooms and corporate suites across the country Sarbanes Oxley has become de rigueur. Sarbanes- Oxley is a part of the curriculum along with business ethics courses in most American business schools. Without Sarbanes-Oxley no one can predict what ruin would have been unleashed on the U.S. economy and global markets. I for one am pleased that it did not reach such proportions

Most important, Sarbanes-Oxley is being embraced by many of our largest corporations. The investment made by corporations that have adopted Sarbanes-Oxley is paying off. In a Harvard Business Review article about Sarbanes-Oxley, the U.S corporations that immediately incorporated Sarbanes-Oxley principles into their business practices have seen a remarkable benefit to their shareholders as well as to their corporate culture. This subset of American business views Sarbanes-Oxley with “gratitude.” Interestingly, the corporations that sat on the fence waiting to follow the lead of others are now playing catch-up.

I predict that in the years to come Sarbanes-Oxley will be worth its weight in more than gold. Sarbanes-Oxley will have almost single handedly rescued American business from self-destruction. Again, I thank the distinguished Chairman of the Committee for his hard work.

TESTIMONY OF CHRISTOPHER COX  
CHAIRMAN  
U.S. SECURITIES AND EXCHANGE COMMISSION  
CONCERNING THE IMPACT OF THE SARBANES-OXLEY ACT

Before the Committee on Financial Services  
U.S. House of Representatives  
September 19, 2006

Chairman Oxley, Ranking Member Frank, and Members of the Committee:

Thank you for inviting me to testify on behalf of the Securities and Exchange Commission concerning the impact of the Sarbanes-Oxley Act of 2002. I am especially pleased to be testifying today alongside Chairman Mark Olson of the Public Company Accounting Oversight Board, with whom I am working very closely to implement the Act.

On this fourth anniversary of the Sarbanes-Oxley Act, I'd like to begin by recognizing the leadership of this Committee under Chairman Oxley and Ranking Member Frank. When President Bush issued his Ten-Point Plan to Improve Corporate Responsibility and Protect America's Shareholders, on March 7, 2002, in the wake of the Enron collapse, this Committee put forward a plan that contained many of those elements. And most of those essential provisions of this Committee's legislation were included in the Conference Report on the final Sarbanes-Oxley Act.

As a member of this Committee at the time, I well remember the significant work that preceded the drafting of the legislation, including extensive hearings, and the considerable effort that you led to shepherd the bill through the legislative process. I particularly remember the House-Senate Conference, and the immediately evident significance of the eventual product: the most sweeping modernization of our system of securities regulation since the initial enactment of the federal securities laws more than 70 years ago.

We have come a long way since 2002. Investor confidence has recovered. There is greater corporate accountability. Financial reporting is more reliable and transparent. Auditor oversight is significantly improved. The legislation that this Committee produced four years ago under your leadership, Mr. Chairman, has helped make that happen.

The Act is not perfect in every respect. But the vast majority of its provisions are net contributors to the nation's economic health. And those parts of SOX that aren't working as well as they should – notably Section 404 – can be made to work better through better implementation. Chairman Olson and I are hard at work on that.

But before providing an update on the Commission's efforts to improve implementation of the Sarbanes-Oxley Act, I would like to highlight a little-noticed fact: While competitors in other countries are using Sarbanes-Oxley as a reason for foreign companies to list in their jurisdictions, many of those same countries are adopting provisions of the Act as part of their own regulatory regimes. As we consider the effect of Sarbanes-Oxley on U.S. competitiveness, it is important to keep in mind how broadly many of its tenets have been taken up overseas.

It would appear, four years later, that America's approach is not unique – we just happened to be early adopters. Of course, each country has implemented reforms in slightly different ways, depending on their national legal system, market conditions, and other factors. But it is still remarkable how similar so many of their reforms are to those passed by Congress four years ago.

Let me give you just some of the examples.

Governments in the major markets around the world have established independent auditor oversight bodies like the PCAOB. For example, the European Union recently adopted a directive requiring all EU member states to create an auditor oversight body. There is now widespread agreement that, to improve audit quality, auditor oversight bodies should be independent of the industry they oversee.

Other major capital markets have also recognized the conflicts of interest that some non-audit services create, and the need to place restrictions on these services to improve audit quality. The European Union, the United Kingdom, France, Hong Kong, China, Japan, Australia, Canada, and Mexico have all passed reforms requiring mandatory audit partner rotation, although they vary regarding the details about how this rotation works.

Audit committee independence is another increasingly common theme around the world. The United Kingdom, Hong Kong, Australia, Canada, and Mexico have all introduced reforms since 2002 requiring that all members of the audit committee be independent of management.

A number of countries have even adopted requirements similar to the first half of the controversial Section 404 of the Sarbanes-Oxley Act, which requires management to do its own assessment of internal controls. Several countries, including the United Kingdom, Australia, and Hong Kong, have adopted a comply-or-explain approach to a management assessment. Japan, France, and Canada all now have legislation or regulations requiring a management assessment of internal controls. Still others, such as Mexico, have corporate governance codes that recommend having a management assessment of internal controls.

The problems we have experienced with Section 404 arise from the implementation of the second half of this provision: the part that requires an auditor evaluation of management's assessment. And just as in America, that aspect has proven more controversial abroad than the assessment itself. Despite the controversy, however, several other jurisdictions have adopted some variant of this requirement.

For example, the UK requires auditors to report on a comply-or-explain basis if they believe management's assessment is unsupported. China, France and Japan have adopted rules requiring an auditor's evaluation of management's report of internal control over financial reporting, but with some differences in the manner in which this evaluation is to be conducted that make it far less costly. Some countries, including Brazil and Australia, require an evaluation, but do not require that the evaluation be made public. Instead, they require the auditor to report this evaluation to the board. Another trend is for corporate governance codes to include a non-binding recommendation for an auditor evaluation, as is done in Germany and Mexico.

Other countries have taken a softer approach to auditor evaluations of management's internal control assessment. Still other jurisdictions, such as Canada, are taking a wait-and-see approach to determine the impact of the auditor attestation requirement in the United States.

Not only with respect to Section 404, but with the entirety of Sarbanes-Oxley, the SEC will continue to work with other regulators around the world to encourage effective regulatory standards that encourage capital formation, job creation, and economic growth, while at the same time offering a high degree of investor protection. As the Congress full well appreciated when it passed Sarbanes-Oxley, these are not inconsistent goals, but rather, highly complementary ones.

Since President Bush signed the Sarbanes-Oxley Act, the Commission has completed nearly 20 rulemakings and studies that were mandated by the Act. Since 2004, the largest public companies, representing more than 95% of the total U.S. market capitalization, have been subject to all of the new rules created by Sarbanes-Oxley. The Section 404 requirements, as I have said, have gotten by far the most attention. But before I continue with a more detailed description of our plans to provide 404 relief, I would like to mention some of the specific improvements that have profoundly and positively affected corporate America, our public investors, and the important work done every day by the Commission.

One of the principal objectives of the Act was to improve executive responsibility and the "tone at the top" at public companies. We can credit two sections of the Act in particular for helping to achieve that objective: Sections 302 and 906. Pursuant to the rules implementing these sections, whenever a public company files a quarterly or annual report with the Commission, both the principal executive officer and the principal financial officer must personally certify that

they have reviewed it. Furthermore, they must affirmatively state that to their knowledge the report does not contain any untrue statement of a material fact and that it does not omit any material information.

A fraudulent Section 302 certification is subject to civil enforcement by the Commission, and a fraudulent Section 906 certification carries criminal penalties enforceable by the Department of Justice. These dual certification requirements are designed to ensure that the company's top leaders are personally involved in the disclosure process. Before investors rely on a company's financial statements, these officers are required to take all reasonable steps to be sure they paint an accurate picture. The Section 302 certification also assigns responsibility to the certifying officers for establishing and maintaining effective disclosure controls and procedures, as well as internal control over financial reporting.

One of the hallmark accomplishments of Sarbanes-Oxley is that it has implemented the corporate equivalent of President Truman's oft-cited aphorism: "The buck stops here." Thanks to SOX, the responsibility for the truthfulness of public corporate reports and disclosures stops on the desks of our corporate leaders.

Another very significant improvement was made by Section 301 of the Sarbanes-Oxley Act. This section embodies the Congress's view that audit committees play a vital oversight role in the financial reporting process. The SEC's rules under Section 301 require that the audit committees of all listed companies be independent. They alone are responsible for the appointment, compensation, retention, and oversight of a company's outside auditor. And the auditor must report directly to the audit committee. The audit committee also must establish the level of funding necessary to fulfill its duties, including, if necessary, the retention of independent counsel and other advisors.

We have long had independent auditors, but their independence rested in large part on their ability to deal with the sometimes conflicting demands from the same executives who selected them and paid their fees. Today's independent audit committees, thanks to Sarbanes-Oxley, can retain their own counsel and other advisers. They now have the resources and protection they need to carry out truly independent evaluations.

In addition, the audit committee must establish procedures for handling whistleblower tips and complaints. That includes a process for accepting such complaints, keeping records of them, and most importantly dealing with them. If a whistleblower seeks to report an accounting or auditing problem confidentially, the audit committee has to have a way to protect his or her anonymity. This is an important new means for companies to discover and correct internal control problems.

Beyond the independence of audit committees, Sarbanes-Oxley has strengthened auditor independence. The entirety of Title II of the Act is devoted to the topic of auditor independence. The intense focus on this topic reflects Congress's appreciation that the audit process is most effective when investors are assured that audits are performed by objective and unbiased professionals. The Act bans auditors from providing the kinds of non-audit services to audit clients that could give rise to financial conflicts of interest. It emphasizes the role of audit committees in approving other services provided by auditors. And it requires audit partner rotation. All of this is more protection for investors, and less incentive for the auditors to do anything that detracts from their core mission.

In January 2003, the Commission amended its auditor independence rules to conform to the Act. As with all of our rules, we are continually monitoring their implementation as we respond to requests from companies and accounting firms for interpretative guidance. The PCAOB also has taken a strong interest in auditor independence and has proceeded with its own rulemaking in this area.

Yet another significant improvement brought about by Sarbanes-Oxley is the change to real-time disclosure of material information by companies and insiders. Today, thanks to changes mandated by the Act, investors are entitled to review reports of insiders' transactions in their companies' securities, including receipt of option grants from their companies, within two business days after the transaction occurs, and all of these reports are now required to be filed on EDGAR, the Commission's electronic filing system.

Recent developments in the areas of executive and director compensation, including our adoption of new disclosure requirements in August and our current enforcement efforts relative to the back-dating of options, demonstrate the importance of these changes.

Furthermore, consistent with Section 409 of Sarbanes-Oxley, in March 2004 the Commission accelerated the deadline for the filing of "current" reports on Form 8-K, and significantly expanded the range of presumptively material events that a company must disclose in those reports. The changes have led to increased scrutiny of the information contained in current reports, including announcements that a company must restate previously issued financial information because of accounting errors or, in some cases, financial fraud.

One of the most significant changes made by the Sarbanes-Oxley Act was the creation of the Public Company Accounting Oversight Board.

Investors were indeed fortunate when, in June 2003, William McDonough, former President of the Federal Reserve Bank of New York, became Chairman of the PCAOB. Under his direction, the PCAOB undertook a number of actions to meet its responsibilities under the Act, including adopting the Board's first professional standards, registering public accounting firms, and initiating its inspection and

disciplinary programs. And under his leadership and that of Acting Director Bill Gradison, who succeeded him last year, the SEC and the PCAOB have established a formal process for the determination of the Board's annual budget and accounting support fees.

On July 3, 2006, Mark Olson became the Chairman of the PCAOB. Chairman Olson is familiar to most of you on this Committee, having served with distinction as a Governor of the Federal Reserve Board of Governors, among other notable positions. Chairman Olson is now working closely with the Commission's new Chief Accountant, Conrad Hewitt, who is a distinguished leader of the accounting profession and the former chief financial regulator for the State of California, as we continue our joint efforts to improve investor confidence in the reliability of audit reports. I must stress how fortunate we are to have people of this caliber charting the course of the PCAOB.

Let me turn now to the one notable exception to the largely positive record of change wrought by the Sarbanes-Oxley Act. The Section 404 internal control reporting requirements, as they have been implemented to date, have met with a variety of criticisms, particularly from smaller companies. What we have learned from our Section 404 compliance efforts to date is that the problems issuers have experienced thus far are not inherent in the language of the statute, but stem rather from the method of its implementation. We have also become convinced that there are no irreparable problems with Section 404 implementation, although fixing the problems that have been identified will be challenging. We are working with the PCAOB to help insure that this provision of the law is implemented efficiently and effectively.

Larger domestic companies with a public float of \$75 million or more have now been fully subject to the Section 404 requirements for two reporting seasons. We have been carefully monitoring compliance efforts each step of the way. On the basis of this experience, we can report that while initial implementation efforts resulted in significantly greater-than-anticipated costs, compliance with Section 404 produces significant benefits. Chief among these benefits is a heightened focus on internal controls at the top levels of public companies.

While a portion of the first-year compliance expense undoubtedly reflected start-up costs -- and, in many cases, long-neglected maintenance by companies of their internal control systems and procedures -- it is undeniable that some of the costs were attributable to excessive, duplicative, or misdirected efforts on the part of companies and their registered public accounting firms.

In response to concerns about these unnecessary costs, the Commission directed the staff to issue additional guidance. An overarching principle of this guidance is that it is management's responsibility to determine the form and level of internal controls appropriate for each company, and to determine the scope of its assessment and testing. The guidance emphasized that the registered public

accounting firms must recognize a range of reasonable choices by companies as acceptable in the implementation of the Section 404 requirements. The PCAOB issued complementary guidance in May and November 2005 regarding the application of its Auditing Standard No. 2.

In May of this year, after carefully evaluating all of the public commentary on the Section 404 requirements, and considering larger companies' experience complying with the requirements, the SEC announced a plan to re-balance Section 404 compliance by all of the companies that fall under our jurisdiction – large and small, foreign and domestic. On May 17, 2006, the Commission issued a roadmap laying out the specific steps we plan to take to make Section 404 compliance more efficient and cost-effective.

One of the significant steps on that roadmap was the publication on July 11, 2006, of a Concept Release as a prelude to the issuance of SEC guidance for management on how to assess the effectiveness of a company's internal controls over financial reporting. This planned new guidance will focus on the objectives of the evaluation process, on the risk-based approaches available to management in conducting an evaluation, and on the documentation of the evaluation. The Concept Release solicits public comment on each of these topics and on whether guidance should be provided on other topics as well. The public comment period on the Concept Release just closed yesterday.

In addition, last month, the Commission proposed to grant some relief from the Section 404 reporting requirements to smaller public companies by extending the date by which non-accelerated filers must start providing a report by management assessing the effectiveness of the company's internal control over financial reporting. The initial compliance date for these companies would be extended by five months, with the result that they would begin complying with the Section 404 requirements in their annual reports for fiscal years ending on or after December 15, 2007. The Commission also proposed to extend the date by which non-accelerated filers must begin to comply with the Section 404(b) requirement to provide an auditor's attestation report on internal control over financial reporting in their annual reports. This deadline would be moved to the first annual report filed for a fiscal year ending on or after December 15, 2008.

At the same time, the Commission proposed a transition period for newly public companies. Under the proposal, a public company that has become public through an initial public offering or a registered exchange offer, or that otherwise has triggered the Exchange Act reporting requirements for the first time, would not be required to provide either a management assessment or an auditor attestation report in the first annual report that it files with the Commission. By not requiring the Section 404 reports until a newly public company files its second annual report, we hope to enhance the attractiveness and cost-effectiveness of participating in our markets both for domestic and foreign

companies contemplating IPOs and for foreign companies considering listing in the U.S. for the first time, without sacrificing important investor protections.

As a separate action taken in August, the Commission granted relief from Section 404(b) compliance for certain foreign private issuers that are accelerated filers. The Commission's data indicate that about 23% of the approximately 1,200 foreign private issuers will receive the one-year extension of the compliance dates.

We anticipate that the SEC staff's next inspection of the PCAOB will focus on the PCAOB's own inspection program for registered audit firms. In particular, the staff will likely focus on the PCAOB's inspections of audits under PCAOB Auditing Standard No. 2.

This authority to inspect the PCAOB is an important aspect of the Commission's general oversight under Section 107(a) of the Sarbanes-Oxley Act. By focusing our next inspection of the PCAOB on its largest program area -- inspections of registered public accounting firms under Sarbanes-Oxley 404 and Auditing Standard 2 -- we hope to achieve greater compliance with the Commission's and the PCAOB's own guidance that these audits be risk-based and cost-effective.

Another important oversight responsibility of the Commission is the approval of the PCAOB's rules and professional standards. During the past year, the Commission approved the PCAOB's proposed Auditing Standard No. 4 and its proposed rules on ethics and independence.

Auditing Standard No. 4, "Reporting on Whether a Previously Reported Material Weakness Continues to Exist," provides guidance to auditors when a company voluntarily engages the auditor to report on previously identified material weaknesses in the company's internal control over financial reporting. Auditing Standard No. 4 provides a mechanism for auditors to report on the correction of material weaknesses without having to wait until the next annual audit of the company's internal controls.

In its order approving the PCAOB's proposed Auditing Standard No. 4, the Commission published guidance stating that both management's report on the correction of the previously reported material weakness and the auditor's related report can be included in any Exchange Act form. Together with Auditing Standard No. 4, this guidance should enable companies to address their investors' concerns about the reliability of the companies' financial statements, thereby achieving an important goal of the Act.

As this brief summary makes clear, Mr. Chairman, much has been accomplished to strengthen and restore integrity to the U.S. capital markets since the enactment of Sarbanes-Oxley four years ago. In a time of crisis, you, then-Chairman Sarbanes, this Committee, and your colleagues in the Senate stepped

forward to champion these significant reforms to our regulatory framework. Your vision and responsible judgment, Mr. Chairman, along with Ranking Member Frank and the other leaders of this Committee, has been absolutely essential in maintaining the standards in our securities markets as the best in the world, in giving America's investors the strongest protection in the world, and in providing them with a higher level of confidence than they can have anywhere else on earth.

In the months and years ahead, we will continue to work to implement the critical reforms effected by the Sarbanes-Oxley Act in the best way possible to meet our objectives of investor protection, well-functioning markets, and healthy capital formation. We will not forget the failures that plagued our markets at the dawn of this millennium, and the crisis in investor confidence that ensued. We will do our best to honor your legacy by ensuring that Sarbanes-Oxley works for every stakeholder -- for investors, for issuers, for our economy, and for our country.

I appreciate the opportunity to speak on behalf of the Commission. I would be happy to answer any questions that you may have.

Testimony Concerning  
Sarbanes-Oxley at Four: Protecting Investors  
and Strengthening the Markets



Mark W. Olson  
*Chairman*  
*Public Company Accounting Oversight Board*

Before the  
Committee on Financial Services

United States House of Representatives

September 19, 2006

Chairman Oxley, Ranking Member Frank, and Members of the Committee:

I am pleased to appear today on behalf of the Public Company Accounting Oversight Board ("PCAOB" or the "Board"). I am also pleased to join Chairman Cox of the Securities and Exchange Commission ("Commission" or "SEC") on this panel. Not only does the SEC oversee the work of the PCAOB, but the PCAOB and the SEC share an important responsibility for investor protection, and therefore naturally work closely together on achieving their mutual mandates.

I want to begin by taking a moment to thank the Committee for its interest in how the PCAOB is fulfilling its statutory mandate.

#### **I. Events Leading Up to Passage of the Sarbanes-Oxley Act**

With more than half of all American households invested in U.S. public companies,<sup>1</sup> the discoveries of financial reporting and auditing improprieties at Enron and numerous other public companies beginning five years ago swelled in 2002 to a national crisis in confidence in the integrity and reliability of public companies' financial statements and of external audits. Before the Act was adopted, the markets were responding to a heightened risk environment that was the product of several contributing factors – including a few beyond the corporate scandals that were seizing headlines. Prior to the scandals, in addition to the unforeseen growth in household

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<sup>1</sup> Due to the expansion of defined contribution plans and other incentives, nearly 57 million U.S. households own stocks directly or through mutual funds, according to a study by the Investment Company Institute and the Securities Industry Association. See *Equity Ownership in America: 2005* (November 2005), available at [http://www.ici.org/pdf/rpt\\_05\\_equity\\_owners.pdf](http://www.ici.org/pdf/rpt_05_equity_owners.pdf).

participation in the financial markets, there was a growing interest in equity markets globally. Market participants were also reeling from the collapse of the dot-com bubble, which was triggering a flight of capital out of certain market segments and causing significant losses for many investors. In addition, there was an emerging sense that while GAAP accounting was well-suited for "brick and mortar" business models, it was not necessarily equipped to capture the underlying financial aspects or purpose of transactions of non-traditional businesses. Then, of course, the Enron and other scandals revealed accounting failures by public companies and tainted the auditing profession – which investors understandably had thought was acting as their watchdog in attesting to the accuracy of the financial reports.

These factors led to a period of heightened risk aversion across the markets that was increasingly adversely affecting innovation and the economy more broadly. Heightened risk aversion led to a predictably strong response on the part of investors, boards of directors at public companies, the accounting profession, regulators, and the Congress. There was an increased recognition of the need to bolster internal controls over financial reporting and bring an enhanced focus to corporate governance. Spurred by this Committee, Congress reacted by passing the Sarbanes-Oxley Act of 2002 (the "Act").

Today, with that brief history as context, I would like to focus on two aspects of the law that involve the PCAOB. The first is the establishment of the PCAOB itself, which replaced the audit profession's self-regulatory model with an independent

oversight system. This change was grounded in the concern that the audit profession's self-regulatory model had not kept up with the growing democratization of the U.S. financial system, which naturally increased reliance on audits as a critical component of the system's integrity. The second is the Act's commitment to managing the risk of future reporting failures through disclosure about the effectiveness of internal controls at public companies.

The PCAOB oversees the auditors of public companies, in order to protect the interests of the investing public in the preparation of informative, accurate and independent audit reports on public company financial statements. The PCAOB does not set accounting standards or regulate disclosures by public companies; rather, its role is to enhance the quality of the audits. Simply put, the PCAOB's job is to improve the quality and reliability of public company audits, so that investors can have more confidence in audited financial statements. High quality financial disclosure by public companies is a cornerstone of capital markets in the United States and is necessary for the continued growth and competitiveness of the U.S. economy.

To explain how the PCAOB aims to achieve its important task, let me describe the PCAOB's oversight philosophy and the current state of its supervisory program. I will then describe in some detail the PCAOB's initiatives to maximize the benefits and minimize the costs of the new internal control audits that are required under the Act. Finally, I will discuss how the PCAOB's work fits into the broader context of Congress's reforms, to make U.S. capital markets stronger and more reliable.

**II. The PCAOB Has Established an Independent Auditor Oversight Program to Protect the Interests of the Investing Public.**

Subject to the oversight authority of the Securities and Exchange Commission, the Board is responsible for --

- Registering public accounting firms that prepare audit reports for issuers;
- Establishing, by rule, auditing and related professional practice standards relating to the preparation of audit reports for public companies;
- Conducting inspections of registered public accounting firms;
- Conducting investigations of, and imposing appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms.

Since the PCAOB opened its doors in January 2003, it has registered more than 1,600 accounting firms that audit, or wish to audit, U.S. public companies. Once registered, these firms become subject to the PCAOB's regulatory programs and must use PCAOB standards when they audit public companies. Accordingly, early on, the Board established a program to set auditing, attestation, quality control, ethics and independence standards applicable to registered firms' audits of public companies. To that end, the Board has developed a standards-setting process that provides for public input at a variety of stages. In particular, three times a year the Board holds a public meeting with its Standing Advisory Group.<sup>2</sup> The advisory group's 31 members are

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<sup>2</sup> The Board convened its Standing Advisory Group pursuant to Section 103(a)(4) of the Sarbanes-Oxley Act. The Group consists of a select group of experts in auditing and financial reporting, including representatives of investors, accountants, and public companies and gathered to advise the Board on its standards-setting responsibilities.

drawn from a cross-section of the nation's companies – from the smallest to the largest – as well as auditors from small and large accounting firms, investors and their advisors, academics, and others. These individuals share their informed opinions on how the Board, consistent with its legislated mandate, can improve the quality of audits, including by advising on best practices and emerging issues. From time to time, the Board also hosts roundtable discussions among other groups of experts and affected parties interested in the Board's development of auditing and related professional practice standards.<sup>3</sup>

In addition, the Board seeks public comment on proposed new standards and rules, makes those comments publicly available on its Web site, and considers them before adopting final standards or rules. Board standards are also subject to SEC review, and they do not go into effect unless they are approved by the SEC. To date, using this deliberative approach, the Board has adopted four new standards as well as new ethics and independence rules relating to tax services and contingent fees.<sup>4</sup>

Registered public accounting firms also are subject to the Board's inspection program, a key element of the PCAOB's oversight. The PCAOB inspects the largest

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<sup>3</sup> For example, in June 2006 the Board sought the advice of its Standing Advisory Group on several topics related to the Board's project to refine its auditing standard on internal control. In addition, in May 2006, together with the SEC, the Board hosted a roundtable discussion on the second year of implementation of the Act's internal control requirements.

<sup>4</sup> Specifically, the Board's Auditing Standard No. 1 relates to references in auditors' reports to the standards of the PCAOB; Auditing Standard No. 2 relates to audits of internal control over financial reporting; Auditing Standard No. 3 relates to audit documentation, and Audit Standard No. 4 relates to auditors' reporting on whether a previously reported material weakness continues to exist. They are available on the Board's Web site at [http://www.pcaobus.org/Standards/Standards\\_and\\_Related\\_Rules/Index.aspx](http://www.pcaobus.org/Standards/Standards_and_Related_Rules/Index.aspx), along with the Board's new ethics and independence rules.

nine firms (the firms that audit the financial statements of more than 100 audit clients) on an annual basis. The PCAOB inspects all other firms that audit (or play a substantial role in the audit of) public company financial statements at least once every three years.<sup>5</sup> Inspections designed to identify auditing problems at an early stage and focus firms on correcting them. They are performed by experienced teams of inspectors, who have on average 13.5 years of relevant experience before they join the PCAOB.

These inspections take a significantly different approach from that of the peer reviews in the pre-Sarbanes-Oxley self-regulatory system, which focused on compliance with applicable standards but did not address the overall audit environment. For one thing, PCAOB inspections begin by looking at the professional environment in which audits are performed and focus on the influences – both good and bad – on a firm's audit practice. These influences include a firm's culture and the relationships between the firm's audit practice and its other practices, as well as between engagement personnel in field or affiliate offices and a firm's national office.

PCAOB inspections are also risk-biased, in that they focus on the aspects of audits that present the greatest risk.<sup>6</sup> When inspectors find an audit that is not satisfactory, they discuss with the firm precisely what the deficiency is. Often this dialogue leads to immediate corrective action.

<sup>5</sup> See PCAOB Rule 4003.

<sup>6</sup> The PCAOB has an Office of Research and Analysis that evaluates both public and non-public information to use in assessing risks for purposes of inspections and other PCAOB programs. Recently, in conjunction with the PCAOB's Office of the Chief Auditor, the Office of Research and Analysis published its first Audit Practice Alert, highlighting for auditors certain issues related to the timing and accounting for stock option grants. That Alert is available on the Board's Web site at [http://www.pcaobus.org/News\\_and\\_Events/News/2006/07-28\\_Release.pdf](http://www.pcaobus.org/News_and_Events/News/2006/07-28_Release.pdf).

From time to time, PCAOB inspections identify potentially inappropriate accounting or other financial reporting by companies. Inspectors bring such matters to the attention of the audit firm. Consistent with its statutory role, the PCAOB does not discuss problems with companies directly, although in many cases the audit firm takes the matter up with the company. In addition, the PCAOB has a practice of notifying the SEC when it identifies financial statements that appear to be materially misstated.

When firms approach inspections with a cooperative attitude, the PCAOB has been able to achieve significant real-time improvements, often even before an inspection is concluded. In addition, after each inspection, the Board issues an inspection report that more formally communicates key findings. Inspected firms have an opportunity to review and comment on a draft of this report before the Board issues it. Parts of inspection reports are made public on the PCAOB's Web site, but, consistent with the confidentiality restrictions in the Act, the full report is transmitted only to the audit firm itself, the SEC and certain state regulators. Under the Act, addressing quality control criticisms within one year after the report results in those criticisms remaining non-public, which provides firms additional incentive to correct problems.<sup>7</sup>

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<sup>7</sup> See Section 104(g)(2) of the Act. The legislative approach reflected in Section 104(g)(2) rests on the premise that firms could be genuinely motivated to improve their quality controls by the prospect of keeping the Board's criticisms confidential. The Board's early experiences with the process generally validate the wisdom of that premise. See PCAOB Release No. 104-2006-078, Observations on the Initial Implementation of the Process for Addressing Quality Control Criticisms within 12 Months After an Inspection Report, March 21, 2006, available at [http://www.pcaobus.org/Inspections/Public\\_Reports/2003/2006-03-21\\_Release\\_104-2006-078.pdf](http://www.pcaobus.org/Inspections/Public_Reports/2003/2006-03-21_Release_104-2006-078.pdf); see also PCAOB Release No. 104-2006-077, The Process for Board Determinations Regarding Firms' Efforts to Address Quality Control Criticisms in Inspection Reports, March 21, 2006, available at [http://www.pcaobus.org/Inspections/2006-03-21\\_Release\\_104-2006-077.pdf](http://www.pcaobus.org/Inspections/2006-03-21_Release_104-2006-077.pdf).

As necessary, the PCAOB investigates auditor conduct and, as appropriate, imposes disciplinary sanctions. In circumstances of reckless conduct or worse, those sanctions can include significant monetary penalties, and also may include revoking a firm's registration (thus preventing it from auditing public companies) or suspending or barring individuals from working on the audits of public companies.

The Committee may be interested in learning of the international implication of the PCAOB's role. More than 700 of the PCAOB's registered firms are in countries outside the United States, reflecting the global nature of auditing and financial reporting today. For the most part, these firms are registered with the PCAOB because they audit or wish to audit significant non-U.S. subsidiaries of multinational U.S. companies or because they audit non-U.S. companies who have caused their securities to trade in U.S. markets and are required to file audited financial statements with the SEC.

The Board's oversight of these non-U.S. registered firms is facilitated by the assistance of new auditor oversight bodies that have formed in countries around the world. Under the Board's rules, in appropriate cases the Board may rely significantly on the inspections and other work of those oversight bodies in achieving its own oversight mandate. In addition, the PCAOB monitors international developments to identify and encourage best practices in audit and related professional practice standards as well as oversight generally. To this end, the Board maintains an ongoing dialogue with its counterparts in numerous other countries.

**III. The PCAOB is Working to Make Internal Control Audits Efficient.**

Section 404 of the Act requires public companies annually to provide investors an assessment of their internal control over financial reporting, accompanied by an auditor's attestation on the same subject. The term "internal control over financial reporting" refers to a company's system of checks and processes designed to ensure that it protects corporate assets, keeps accurate records of those assets as well as its financial transactions and events, and prepares accurate periodic financial statements. Investors can have much more confidence in the reliability of a corporate financial statement if corporate management demonstrates that it maintains adequate internal control over bookkeeping, the sufficiency of books and records for the preparation of accurate financial statements, adherence to rules about the use of company assets and the safeguarding of company assets.

**A. The Act's Internal Control Reporting and Auditing Requirements and the PCAOB's Auditing Standard No. 2.**

As directed by Section 404(a) of the Act, in June 2003 the SEC established rules describing the required assessments by public companies. In March 2004, the PCAOB implemented Sections 103 and 404(b) of the Act by establishing a new auditing standard – Auditing Standard No. 2 – to provide for an integrated audit of both internal control over financial reporting and the financial statements themselves. The SEC approved Auditing Standard No. 2 in June 2004.<sup>8</sup> For large, established companies –

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<sup>8</sup> See SEC Release No. 34-49884, Order Approving Proposed Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (June 17, 2004).

which the SEC calls accelerated filers – the initial assessments and attestations were required by SEC regulations to be included in their annual Form 10-K filings for fiscal years ending after November 14, 2004.<sup>9</sup>

**B. The PCAOB Has Monitored Auditors' Implementation of Auditing Standard No. 2 and, as Needed, Provided Guidance.**

In the two years since the SEC's rule on management assessments of internal control and the Board's related auditing standard went into effect, companies and auditors have faced significant unanticipated implementation challenges. These challenges led to a number of problems, including expenditure of unnecessary effort and cost in some situations. The Board has closely monitored these challenges and, as appropriate, provided additional guidance to facilitate implementation. In this regard, the Board's staff has issued five sets of interpretive guidance that answer 55 frequently asked technical questions on the implementation of Auditing Standard No. 2.<sup>10</sup> In addition, on May 16, 2005, the Board issued a policy statement describing ways auditors can make their internal control audits as effective and efficient as possible.<sup>11</sup> In particular, the Board explained that, to properly plan and perform an effective audit under Auditing Standard No. 2, auditors should –

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<sup>9</sup> The SEC's rules have not yet become effective for non-accelerated filers.

<sup>10</sup> These questions and answers are available at [http://www.pcaobus.org/Standards/Standards\\_and\\_Related\\_Rules/Auditing\\_Standard\\_No.2.aspx](http://www.pcaobus.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.2.aspx).

<sup>11</sup> See PCAOB Release No. 2005-009, Policy Statement Regarding Implementation of Auditing Standard No. 2 (May 16, 2005).

- *integrate their audits* of internal control with their audits of the client's financial statements, so that evidence gathered and tests conducted in the context of either audit contribute to completion of both audits;
- *exercise judgment to tailor their audit plans to the risks facing individual audit clients*, instead of using standardized "checklists" that may not reflect an allocation of audit work weighted toward high-risk areas (and weighted against unnecessary audit focus in low-risk areas);
- *use a top-down approach* that begins with company-level controls, to identify for further testing only those accounts and processes that are, in fact, relevant to internal control over financial reporting, and *use the risk assessment required by the standard* to eliminate from further consideration those accounts that have only a remote likelihood of containing a material misstatement;
- take advantage of the significant flexibility that the standard allows to *use the work of others*, including corporate internal audit departments; and
- *engage in direct and timely communication with audit clients* when those clients seek auditors' views on accounting or internal control issues before those clients make their own decisions on such issues, implement internal control processes under consideration, or finalize financial reports.

The Board also announced that it would monitor the effectiveness and efficiency of such audits in its inspections of the largest firms. The Board's first such inspections, as well as its other efforts to monitor the implementation of Auditing Standard No. 2, resulted in its issuance of a Report on the Initial Implementation of Auditing Standard No. 2 on November 30, 2005.<sup>12</sup> The Board noted in that report that, in the first year, many auditors faced tight deadlines, staffing and other resource constraints, and significant training needs. Moreover, their clients faced similar hurdles that were, in many cases, exacerbated by having to make up for deferred maintenance on internal

<sup>12</sup> See PCAOB Release No. 2005-023, Report on the Initial Implementation of Auditing Standard No. 2 (November 30, 2005), available at [http://www.pcaobus.org/Rules/Docket\\_014/2005-11-30\\_Release\\_2005-023.pdf](http://www.pcaobus.org/Rules/Docket_014/2005-11-30_Release_2005-023.pdf).

control systems that had not kept up with the company's growth and development. Given these challenges, as the report noted, the Board found that firms' first-year audits of internal control were not as efficient as they should be.

**C. The PCAOB Intends to Continue to Improve Implementation of the Act's Internal Control Reporting Requirements, Including Eliminating Any Procedures That Are Unnecessary to Achieve the Intended Benefits.**

The Board is determined to make internal control audits as cost-effective as possible for companies that are required by the SEC's rules to obtain an audit report on internal control, and to that end the PCAOB continues to explore ways to improve its audit requirements and accounting firms' implementation of them, while preserving the intended benefits. In addition to considering changes to its standard, the PCAOB has also designed its 2006 inspections of registered public accounting firms to examine how efficient firms' internal control audits have been, as measured by PCAOB's past guidance.<sup>13</sup> Inspectors are probing firms' second-year audits according to this approach. The Board expects these inspections to drive more efficiency into audits.

**1. *The Board Will Soon Consider Changes to Its Standard, to Promote Efficiency and Eliminate Unnecessary Procedures.***

In May 2006 the Board announced plans to propose and seek comment on amendments to Auditing Standard No. 2 to focus auditors on areas that pose higher risk

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<sup>13</sup> See PCAOB Release No. 104-2006-105, Statement Regarding the Public Company Accounting Oversight Board's Approach to Inspections of Internal Control Audits in the 2006 Cycle (May 1, 2006), available at [http://www.pcaobus.org/Inspections/2006-05-01\\_Release\\_104-2006-105.pdf](http://www.pcaobus.org/Inspections/2006-05-01_Release_104-2006-105.pdf).

of fraud or material error.<sup>14</sup> These amendments should reinforce the Board's expectation that the audit be as efficient as possible. I support this initiative wholeheartedly, and indeed the Board is well on its way to proposing a new version of its standard later this fall.

It is the Board's intention that the proposal will achieve four goals. *First*, the PCAOB is critically evaluating every area of the audit to determine whether the existing standard encourages auditors to perform procedures that are not necessary to achieve the intended benefits of the audit. In particular, the Board plans to consider eliminating any suggestion that auditors need to evaluate the process that a company uses to reach its conclusion about the effectiveness of company controls. Instead, auditors' work would clearly be limited to evaluating whether, in the auditor's opinion, the company's internal control is designed and operating effectively, without intruding on management's process to reach its conclusion. Also, the Board plans to propose permitting auditors to reduce their work after the first year, if controls have not changed from year to year.

*Second*, the Board plans to propose changes to make the standard simpler to read, easier to understand and more clearly scalable to companies of any size. To do so, the Board is considering reduction in detail in a number of areas, as well as re-articulation of some complex definitions and other concepts that have unintentionally

<sup>14</sup> See PCAOB News Release, Board Announces Four-Point Plan to Improve Implementation of Internal Control Reporting Requirements (May 17, 2006), available at [http://www.pcaobus.org/News\\_and\\_Events/News/2006/05-17.aspx](http://www.pcaobus.org/News_and_Events/News/2006/05-17.aspx).

caused auditors and managers unnecessary time to learn and apply. At the same time, by emphasizing core principles, the new proposal is expected to focus auditors on the importance of identifying material weaknesses prior to an actual misstatement occurring, which should greatly benefit investors and restore further confidence in the audit profession.

*Third*, the Board plans to propose changes that would make explicit in the standard the Board's past guidance on how to make internal control audits as efficient as possible. While this guidance has been in place for some time already, we have heard from auditors and others that improvements in efficiency would likely result from incorporating that guidance into actual rule text.

*Fourth*, in order to focus auditors on what really matters, which is identifying material weaknesses in a company's system of internal control *before* those weaknesses result in material misstatements in the company's published financial statements, the proposal should emphasize the importance of a company's control environment, and how it can impact the risk of financial reporting fraud or other material failure. It should also emphasize higher risk stages of financial statement preparation, such as the period-end close process that, when overridden by aggressive managers seeking to appear to meet market targets, has provided the opportunity for so many financial frauds in the past. To the extent the Board's standard can provide more insight into how auditors should identify these risks and weaknesses, it will better serve investors.

**2. *The Board Plans Guidance for Auditors of Small Companies.***

The Board is determined to make internal control audits as cost-effective as possible for companies that are required by the SEC's rules to obtain an audit report on internal control. Among other things, based on the experience of small companies and auditors who have been – and are currently going – through the process of establishing and evaluating internal control, the Board is working with practitioners to develop implementation guidance for auditors of smaller public companies.

This guidance should emphasize the scalability of internal control audits at a practical level and provide audit firms with examples of how the internal control audit process can and should be scaled to fit the relative sizes of small companies, from those that are on the cusp of accelerated filer status down to those that have merely a handful of employees. In addition, the Board is exploring various means of facilitating training for auditors of smaller public companies on auditing internal control. With constructive, practical guidance, and with the SEC's recent announcement extending the time frame for implementing the Act's internal control requirements, the Board hopes that small companies and their investors will be able to reap the benefits of internal control reporting without unnecessary costs.

**3. *The Board is Continuing Its Forums on Auditing in the Small Business Environment.***

In late 2004, the Board embarked on an ambitious outreach effort directed toward small accounting firms and the small public companies they audit. Specifically,

the Board has conducted a series of one- and two-day discussion sessions with small firms and their audit clients, focusing on the topic "Auditing in the Small Business Environment." To date, the Board has held 15 Forums in 14 cities.<sup>15</sup> These Forums have fostered a robust dialogue and given the PCAOB valuable insights to apply in its standards-setting and other programs. They have also better equipped small firms with useful information to address the challenges of the new regulatory environment.

**IV. Reforms in Financial Reporting Have Strengthened the Foundation for Strong U.S. Markets.**

Four years after scandals rocked investor confidence and led to the passage of the Sarbanes-Oxley Act, we are able to evaluate the extent to which investors are recognizing improvement in the reliability of financial reporting by U.S. public companies. In some ways, the Act codified best practices that had begun to emerge immediately following the scandals. The Act ensured that boards of public companies and their auditors would reassess the roles of audit committees and the integrity of financial reporting and assign responsibility for assuring that internal control over financial reports would be discharged in a meaningful way.

Today, we are in a better position to reflect on the impact of the Act and whether we are on the right track to achieve its objectives. I believe we have seen restored investor confidence in financial reporting. We are also seeing audit firms realign their

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<sup>15</sup> Beginning in November 2004, the PCAOB has held Small Business Forums in Atlanta, Boston, Chicago, Dallas, Denver, Fort Lee (New Jersey), Orange County (California), Orlando, Pittsburgh and San Francisco. In 2006, the Board has held forums in Santa Monica, Fort Lauderdale, San Antonio, Seattle and Boston and has scheduled sessions in Philadelphia, New York and Chicago.

business models to focus on quality audit services, ethics, and appropriate levels of independence.

The PCAOB understands that these milestones have not been reached without cost. For example, we continue to hear concern that the costs associated with Section 404 of Sarbanes-Oxley have weakened U.S. markets, pointing to recent growth in non-U.S. markets. I would encourage the Committee to evaluate the cost/benefit broadly and over an extended period of time. To be sure, many markets outside of the United States have risen to become global players, due to a number of factors, including ease of information exchange and the reduction of certain barriers to cross-border transactions. Companies today are presented with more options when they are determining where to raise capital. Regulatory regimes as well as local political and cultural influences are often factored into this decision. We should welcome competition among markets around the globe but not support a competition that is based on cost alone. Having the right balance of oversight and regulation protects the reliability, stability and depth of U.S. capital markets, so they can continue to attract investors and issuers worldwide.

Listings on U.S. markets continue to command a valuation premium.<sup>16</sup> Indeed, in the two years since companies have been reporting and obtaining audits on their internal control, the amount of capital raised by non-U.S. companies on U.S. exchanges

<sup>16</sup> Remarks of Noreen Culhane, Executive Vice President, Global Corporate Client Group, New York Stock Exchange, printed in Ernst & Young, *Accelerated Growth: Global IPO Trends 2006*, at 26 (An "underlying motivation for most companies listing in the U.S. is the valuation premium (average 30 percent) that accrues as a result of adhering to high standards of governance.").

has grown, not shrunk as it did in the years directly after the scandals.<sup>17</sup> Even with the expansion of equity markets in other countries, I expect that we will see a continued dominance of U.S. capital markets, particularly in the long term.

#### V. Conclusion

The PCAOB works hard to achieve the objectives Congress set for it. The oversight program it has in place is contributing to a reduction in the risk of financial reporting failures and contributing to a renewed confidence in financial reports of publicly traded companies and ultimately in the U.S. securities markets. Now in its fourth year of operation, the PCAOB has established a strong foundation for its oversight of public company auditors. The Board continues to assess its oversight program, however, and will make appropriate adjustments to assure that it achieves the objectives of the Act in the most effective and efficient manner possible. In particular, the Board is committed to ensuring that its standard on internal control lays the foundation for efficient, risk-based audits. Reconsideration of Auditing Standard No. 2 on internal control is just one example of this process, though. The PCAOB's oversight role – as enunciated in the Act and implemented over the past four years -- has already produced positive results.

The PCAOB model clearly resonates in countries that are seeking to strengthen the integrity of their own capital markets, and we are increasingly seeing other nations implement this model to auditor oversight in varying degrees.

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<sup>17</sup> See Cowan, Lynn, "Foreign Companies Cash in on U.S. Exchanges, *Wall Street Journal*, August 28, 2006, at C6.

While, as I have described, it is important to eliminate unnecessary regulatory costs, vigilance in that regard should not detract from the fundamental reasons for the long-standing strength of U.S. markets. That strength has been due in large part to the high quality standards and investor protections that have been the trademark of those markets for decades.

Thank you Mr. Chairman and Members of the Committee. I welcome your questions.

CHRISTOPHER COX  
CHAIRMAN  
—  
HEADQUARTERS  
100 F STREET, NE  
WASHINGTON, DC 20549

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION



REGIONAL OFFICES  
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FORT WORTH, SALT LAKE CITY,  
SAN FRANCISCO

December 19, 2006

The Honorable Michael Oxley  
Chairman  
Committee on Financial Services  
U.S. House of Representatives  
2129 Rayburn House Office Building  
Washington, DC 20515

Dear Chairman Oxley:

This letter and the attached memorandum from the Commission's Office of the Chief Accountant relate to my September 19, 2006 testimony before the Committee. They respond to your follow-up questions for the record regarding certain public limited partnerships that are registered with the Securities and Exchange Commission that invest in affordable housing principally to realize federal housing tax credits.

Over the last several months, the Commission staff has held a number of meetings and conference calls with representatives from the low income tax credit housing industry in order to obtain an understanding of the issues and to be responsive to their concerns. As you noted, the Commission staff issued a letter on April 21, 2006 indicating we would provide temporary relief from certain of our independence requirements. Further, the Commission staff is continuing to meet with these registrants to fully address their concerns and issues and determine the best course of action. The attached memo to me from Conrad Hewitt, the Commission's Chief Accountant, will hopefully provide you with the additional information requested in your questions.

Thank you for your interest in this matter. Please call me at (202) 551-2100 or have your staff contact Jane Cobb in the Office of Legislative Affairs at (202)-551-2010, if you have any questions or would like further information.

Sincerely,

Christopher Cox  
Chairman

Attachment

CHAIRMANOFFICE@SEC.GOV  
WWW.SEC.GOV

**Memorandum****To:** Chairman Cox**From:** Conrad Hewitt, Chief Accountant**Re:** Response to questions from Chairman Oxley and Ranking Member Frank in connection with your testimony of September 19, 2006**Date:** December 1, 2006

*Certain publicly offered limited partnerships registered with the Securities and Exchange Commission invest in affordable housing principally to realize federal housing tax credits. The partnerships then allocate these tax credits to their investors. In addition to the federal securities laws, these partnerships and/or their housing investments are subject to federal tax and federal and state housing laws and regulations. Given the multiple regulatory regimes, what is your assessment as to the utility of applying to these partnerships the Commission's and the Public Company Accounting Oversight Board's auditing standards, including requirements relating to auditor independence, second partner review, and completion memoranda?*

Based on the Commission staff's discussion with industry representatives, it is our understanding that the limited partnerships are concerned about the differences between the auditing and auditor independence requirements of the American Institute of Certified Public Accountants (AICPA) and the Public Company Accounting Oversight Board (PCAOB). However, the staff is not aware of significant differences between the two sets of auditing standards in the particular areas that have been brought to our attention. These areas are discussed below.

As background, prior to the creation of the PCAOB, auditors performed their engagements in accordance with generally accepted auditing standards as established by the AICPA. Those standards required that "in all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor."<sup>1</sup> Additionally, the AICPA's independence standards specifically required that the auditor take into consideration the AICPA's independence requirements<sup>2</sup> and, when the audit report will be filed with the SEC, the SEC's independence requirements.<sup>3</sup>

Upon the establishment of the PCAOB, the PCAOB adopted the auditing standards of the AICPA that were in place as of April 16, 2003 as the PCAOB's interim standards. Since that date, the PCAOB has only adopted four new auditing standards, none of which significantly impact the auditor independence requirements that were in effect under the AICPA.<sup>4</sup>

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<sup>1</sup> See AU Section 220, Independence.

<sup>2</sup> The AICPA's independence requirements are established in the AICPA's Code of Professional Conduct.

<sup>3</sup> See AU Section 220.

<sup>4</sup> Two of the PCAOB's new standards relate to auditing the effectiveness of internal control over financial reporting and are not applicable to these partnerships. The other two standards provide requirements relating to the language in the auditor's opinion and documentation to support the audit. The documentation standard requires that the auditor prepare a completion memorandum at the conclusion of each engagement – a requirement which the staff

Based on the Commission staff's discussions with representatives from these partnerships, we understand that the primary independence questions arise from the fact that auditors of the individual partnerships frequently prepare the financial statements. However, the auditor independence requirements have not been modified in this area by the PCAOB. The Commission's 2001 independence rules prohibit auditors from preparing financial statements that are filed with the Commission on the basic premise that the auditor cannot audit his or her own work and remain independent. As discussed above, compliance with the Commission's independence standards was required by the AICPA's auditing standards and continues to be required under the PCAOB's auditing standards. As a result, the prohibition on types of services in question are not new requirements of the PCAOB, but were requirements that were in existence under the AICPA as well.

Representatives from the limited partnerships have also raised concerns about the requirement for "second partner review" under the PCAOB standards, primarily because of the limited number of partners in the audit firms that audit the majority of the limited partnerships. Again, this is a situation where the requirements for a second partner review have not been modified by the PCAOB. Requirements for second partner review were originally established by the AICPA's SEC Practice Section. However, the requirements of the AICPA SEC Practice Section were only mandatory for those firms that were members of the practice section, and membership was voluntary. When the PCAOB adopted their interim standards, they adopted the requirements of the AICPA SEC Practice Section that existed as of April 16, 2003 but made those requirements only mandatory for the accounting firms that were members of the AICPA SEC Practice Section as of that date. Therefore, any firm that was not a member of the SEC Practice Section as of April 16, 2003 is not required to have second partner reviews performed on their audit engagements under the PCAOB auditing standards. We understand the vast majority of the auditors of the individual partnerships were not members and therefore the second partner review does not apply to their audits. There are a few larger audit firms that were members of the AICPA's SEC Practice Section and therefore the second partner review continues to apply to them.

*What is your assessment of the potential impact of these auditing standards on investors, partnerships, and affordable housing projects? Additionally, we understand that the Commission's staff has provided temporary exemptions from certain of these auditing standards to some of these partnerships. What are your views as to the impact of these exemptions and the appropriateness of making these permanent?*

The Commission staff has met with representatives from the low income housing tax credit industry a number of times over the past year in order to obtain a better understanding of the impact of the Commission's independence rules and the PCAOB's auditing standards on this industry. We have also committed to make ourselves available for further meetings, if needed. Based on what we have learned from the representatives to date, we believe that the impact of the issues addressed above should not be unduly burdensome. For example, currently the limited partnerships are paying the auditor to perform the services in question (i.e. preparation of the financial statements) as part of their audit fee. We believe that the partnerships could split these

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believes does not involve significant incremental effort on the behalf of the auditor and that we understand was already occurring at the majority of the audits.

services out from the audit fee and hire a third party to complete such services or the services could be performed at the limited partner for each of the individual partnerships, which should achieve greater efficiencies. While we acknowledge that there may be some incremental costs by having to involve an additional vendor to obtain the services, we do not believe that such costs will be prohibitive.

The Commission staff has provided a temporary exemption from certain of the Commission's independence requirements in a letter dated April 21, 2006 by indicating that the staff will not assert that the auditor's independence was violated solely because the auditor compiled the financial statements for the operating partnerships for 2005 and prior. From time to time, the Commission staff has determined that providing such exemption for prior violations of the independence requirements is the best way to balance between protection of the investor and disruption of the issuer's reporting obligations and, potentially, their access to the capital markets. However, neither the Commission nor its staff has ever provided a permanent exemption from the Commission's independence rules.

The Commission staff believes that the SEC's independence requirements fulfill important public policy goals. Because the financial information filed with the Commission must be audited by independent public accountants, the accountants serve as one of the primary "gatekeepers" of the public securities markets. As a result, the Commission staff has concern with the notion of permanently exempting auditors from the independence requirements and would be reluctant to allow an auditor to violate on an ongoing basis such a fundamental premise as the prohibition from auditing his or her own work. The staff believes that a permanent exemption would result in providing investors in these limited partnerships with less protection than is received by investors in other securities.

CHRISTOPHER COX  
CHAIRMAN

HEADQUARTERS  
100 P STREET, NE  
WASHINGTON, DC 20549



UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

REGIONAL OFFICES  
NEW YORK, CHICAGO,  
LOS ANGELES, DENVER, MIAMI  
DISTRICT OFFICES  
BOSTON, PHILADELPHIA, ATLANTA,  
FORT WORTH, SALT LAKE CITY,  
SAN FRANCISCO

December 27, 2006

The Honorable Patrick T. McHenry  
Committee on Financial Services  
U.S. House of Representatives  
224 Cannon House Office Building  
Washington, DC 20515

Dear Patrick:

I am pleased to address two questions that you submitted for my response following the Financial Services Committee's recent hearing on the Sarbanes-Oxley Act.

First you asked whether the Sarbanes-Oxley Act gives the Securities and Exchange Commission the authority to exempt financial institutions that are already subject to duplicative regulation under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). The source of exemptive authority depends on the Sarbanes-Oxley provision at issue, and we discuss Section 404 exemptive authority below. The Commission has both exemptive and rulemaking authority under the federal securities laws, including the Securities Act of 1933 and the Securities Exchange Act of 1934. While the Sarbanes-Oxley Act does not explicitly provide the Commission with general exemptive authority, many of the provisions of the Sarbanes-Oxley Act were enacted as amendments to the Securities Act and the Exchange Act; and, therefore, such provisions are subject to the Commission's general exemptive authority in those acts. In addition, Section 3(a) of the Sarbanes-Oxley Act authorizes the Commission to promulgate rules and regulations in furtherance of that act. The Commission's exemptive and rulemaking authority gives the Commission a variety of ways to provide exemptions or relief in appropriate cases. The approach in any particular case will depend upon the specific facts and circumstances.

Your second question was whether the Sarbanes-Oxley Act gives the Commission the authority to exempt bank holding companies from Section 404 should the rationale exist to do so. Various legal commentators have debated this question without reaching consensus. To illustrate the legal debate, I am enclosing an analysis from the April 23, 2006 Final Report to the Commission of the Advisory Committee on Smaller Public Companies, an entity chartered by the Commission in March 2005 to assess the current regulatory system for smaller companies under the federal securities laws, as well as a contrasting view articulated in a letter, also enclosed, that the Committee received from Professor James D. Cox of the Duke University School of Law and nineteen other law professors.

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The Honorable Patrick T. McHenry  
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I want to assure you there is no question of our dedication and the priority we are giving to on-going efforts to address the undue costs of the regulatory burden associated with compliance with Section 404. Since I testified before you in September, the Commission and the PCAOB have proposed changes to our Section 404 standards and guidance in ways we intend will significantly improve the implementation of Section 404. We remain committed to using the resources available to us to ensure that the rules implementing Section 404 are made to work efficiently and effectively for all issuers, while maintaining the important investor protections that the statute provides.

I appreciate your questions and your on-going interest in these important issues. Please feel free to call me at (202) 551-0000 or have your staff call Jane Cobb, Director of the Office of Legislative Affairs, at (202) 551-2010 if you have any additional questions or comments.

Sincerely,  


Christopher Cox  
Chairman

Attachments

**Excerpt from the Final Report of the Advisory Committee on Smaller Public Companies (2006), Footnote 110.**

We are aware that questions have arisen regarding the Commission's authority to provide exemptive relief from full compliance with the requirements of Section 404 in accordance with this recommendation and the recommendation above. As a committee, we are not authorized or capable of rendering legal opinions on this issue. We are aware, however, that Section 3(a) of the Sarbanes-Oxley Act, 15 U.S.C. 7202(a), provides the Commission with broad authority to promulgate "such rules and regulations as may be necessary or appropriate in the public interest or for the protection of investors" in furtherance of Section 404. We believe that the relief we propose satisfies this standard and that the reasoning we have provided for our recommendations demonstrates the reasonableness of this conclusion. Furthermore, we are aware of the view expressed by the Committee on Federal Regulation of Securities of the American Bar Association's Section of Business Law that the Commission has authority to provide exemptive relief for smaller public companies from strict adherence to technical requirements of Section 404, as follows:

"We believe the Commission's authority [to provide relief from the auditor attestation requirements in Section 404(b) for smaller public companies] stems from both the [Exchange Act] and [the Sarbanes-Oxley Act] itself. Section 36(a)(1) of the Exchange Act gives the Commission broad exemptive authority under the Exchange Act. [Sarbanes-Oxley] section 3(b)(1) provides that a violation of [the Act's provisions] will be treated as a violation of the Exchange Act. Therefore, under Exchange Act Section 36(a)(1), the Commission can adopt rules exempting classes of persons (here, smaller public companies) from compliance with [Sarbanes-Oxley] provisions, including . . . Section 404(b)."

Letter from Committee on Federal Regulation of Securities, American Bar Ass'n, to SEC, p.4 n.2 (Nov. 28, 2005) (on file in SEC Public Reference Room File Nos. S7-40-02 & S7-06-03), available at <http://www.sec.gov/rules/proposed/s70603/aba112805.pdf>. We also are aware that the Commission's broad rulemaking authority under Section 36(a)(1) of the Exchange Act may be exercised to provide exemptive relief from the requirements of Section 13(b)(2)(B) of the Exchange Act, the provision that requires public companies to devise and maintain the systems of internal accounting controls that are the subject of management's internal control report and the auditor's report required under Section 404. We also are aware that the Commission itself already has provided exemptive relief from Section 404 for certain reporting entities, such as asset-backed issuers, indicating that the SEC believes it has exemptive authority to provide relief from technical compliance with Section 404. We believe the Commission could cite these and other authorities to demonstrate its authority to provide exemptive relief from the requirements of Section 404. In addition, the Commission could consider applying the canon of construction known as "in pari materia" to construe Section 404 as subject to the Commission's broad exemptive authority in the Exchange Act because the two statutes relate to the same subject matter and must be construed harmoniously. These views were supported in a letter to SEC Chairman Christopher Cox from Representative Oxley, one of the original sponsors of the Sarbanes-Oxley Act, and Representative Baker, the current Chairman of the House Financial

Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises. See Letter from Rep. Michael G. Oxley and Rep. Richard H. Baker to SEC Chairman Christopher Cox (Mar. 2, 2006), available at <http://www.sec.gov/rules/other/265-23/mgoxley030206.pdf>. A different view as to the Commission's authority under Section 36(a) was expressed in a letter from Professor James D. Cox and 19 other law professors, although the professors acknowledged that “[s]pecific disclosure requirements tailored to the unique risks and likely regulatory benefits of smaller public companies are entirely appropriate and consistent with the rulemaking authority the Commission enjoys under Section 3(a) of the Sarbanes-Oxley Act.” See Letter from James D. Cox, et al. to Committee (Mar. 21, 2006), available at <http://www.sec.gov/rules/other/265-23/26523-309.pdf>.

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March 21, 2006

The Honorable Christopher Cox  
Chairman  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549



Re: Response to SEC Release 33-8666 Seeking Comments on the Exposure Draft of the Final Report of the Advisory Committee on Small Business

Dear Chairman Cox:

I, and the many law professors who appear on the attached co-signers' page, join in this letter to express our deep reservations regarding the legal authority of the Securities and Exchange Commission to exempt "micro-cap" registrants from the provisions of section 404 of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). The proposed exemption appears in the draft report of the SEC's Advisory Committee on Smaller Public Companies and, pursuant to the definition set forth in the draft, the exemption would remove nearly eighty percent of all U.S. public companies from the requirements of section 404.

As law professors whose research and teaching focus on securities regulations, we have examined the permissible scope of the SEC's authority to promulgate exemptions pursuant to section 36(a) of the Securities Exchange Act of 1934. It is our opinion that section 36(a) of the Securities Exchange Act, or for that matter section 3(a) of Sarbanes-Oxley, does not empower the SEC to exempt issuers from section 404 of Sarbanes-Oxley.

Our conclusion is compelled by the below underscored language of section 36(a):

[T]he Commission, by rule, regulation, or order, may conditionally or unconditionally exempt any person . . . or any class or classes of persons . . . from any provision or provisions of this title or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

The expression "of this title" refers to Title I of the Exchange Act. Thus, section 36(a) does not reach other securities law statutes that are within the SEC's jurisdiction, for example the Public

Utility Holding Company Act of 1935, the Investment Company Act of 1940 or the Investment Advisers Act of 1940. Because section 404 of Sarbanes-Oxley is not part of the Exchange Act, it falls outside section 36(a). This conclusion is supported by the committee report accompanying the enactment of the National Securities Markets Improvement Act of 1996 which explains the exemptive authority being provided in both section 28 of the Securities Act and section 36(a) to the Securities Exchange Act as applying only to the provisions of their respective titles.

"This section adds a new Section 28 to the Securities Act to provide the Commission with the authority, by rule or by regulation, to conditionally or unconditionally exempt any person, security, or transaction, or any class of the same, from any provision or provisions of the Act or any rule or regulation thereunder. . . . The legislation adds a new Section 36 to the Exchange Act to provide the Commission with authority under the Exchange Act similar to that contained in new Section 28 of the Securities Act." See H.R. Rep. 104-622, 1996 U.S.C.C.A.N. 3877, at 3900-01

The conclusion that "of this title" refers only to the Securities Exchange Act is further supported by this same expression appearing in section 28 of the Securities Act, section 6(c) of the Investment Company Act, and section 206A of the Investment Advisors Act. Thus, each of these major acts expressly authorize the SEC to establish exemptions but only for "any provision or provisions of this title." When each of these sections are considered, the inescapable conclusion is that none of them provide authority for the SEC to create exemptions other than from the provisions of the particular act whose exemptive authority the SEC has invoked for that exemption.

The Congress, by not imbedding section 404 of Sarbanes-Oxley in the Exchange Act as it did with so many of its other Sarbanes-Oxley provisions, thereby chose to remove section 404 from the SEC's authority to exempt reporting companies from the requirements of section 404. The exclusion of section 404 from the Exchange Act is particularly revealing in view that Exchange Act Section 13(b)(2)(B) mandates that reporting companies "devise and maintain a system of internal accounting controls. . ." If Congress had desired section 404's requirements to be subject to Exchange Act qualification or exemptions that the SEC can adopt pursuant to section 36(a) of the Exchange Act, the natural step for Congress to have taken when enacting section 404 was to cast it as an amendment to Section 13(b)(2). Congress did not do this.

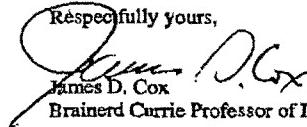
The conclusion that Congress intended all reporting issuers to be subject to section 404, and therefore beyond the power of the SEC to adopt exemptions under section 36(a) of the Exchange Act, is further supported by the language of section 404 which requires that the SEC "prescribe rules requiring each annual report" of a reporting company include assessment by management of internal controls as well as the independent auditor's attestation of management's assessment. Congress certainly envisioned that management's assessment and the auditor's attestation would occur for "each annual report" of reporting companies. Hence, a broad exemption, in addition to being outside the powers the SEC has under section 36(a) of the Exchange Act would also be inconsistent with Congress' clear intent in adopting section 404. Given this conclusion, we also do not believe that section 3(a) of Sarbanes-Oxley can reasonably be read to provide such authority.

The preceding analysis does not mean, however, that the SEC and PCAOB are without authority to tailor section 404 requirements differently for smaller issuers. Sarbanes-Oxley does not authorize the SEC to grant exemptions from its provisions. Instead Sarbanes-Oxley in section 3(a) of Sarbanes-Oxley requires the SEC to promulgate rules and regulations "in furtherance of this Act" that are "in the public interest or for the protection of investors." Specific disclosure

requirements tailored to unique risks and likely regulatory benefits of specific classes of registrants are entirely appropriate and consistent with the rulemaking authority the SEC enjoys under section 3(a) of Sarbanes-Oxley.

We believe a far wiser course for the SEC and the PCAOB is to closely evaluate the reporting risks associated with internal controls of various issuer classes and develop an appropriate framework for section 404 compliance by smaller public companies. In making this evaluation the SEC and the PCAOB should understand that there is abundant empirical evidence that financial reporting violations most frequently involve companies whose market capitalization does not exceed \$250 million. This approach is far more consistent with the SEC's overall mission than if it were to grant a sweeping exemption, which we believe is unlawful, of nearly eighty percent of reporting companies from any internal control assessment by its senior management and attestation by the firm's auditors.

Respectfully yours,



James D. Cox  
Brainerd Currie Professor of Law

cc: Paul A. Atkins, Commissioner  
Roel C. Campos, Commissioner  
Cynthia A. Glassman, Commissioner  
Annette L. Nazareth, Commissioner

**Co-Signers of Letters**

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